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BOOK REVIEWS

Cost Accounting

By Adolph Matz, Othel J. Curry and George W. Frank. SOUTH-WESTERN PUBLISHING COMPANY, New Rochelle, N. Y., 1952. Pages: x + 805; $5.50.

The arrival of a new text in cost accounting always gives this reviewer an anticipatory thrill which may or may not wear off as he begins to read it. In the present instance, he found himself well repaid for the effort. The book represents a complete, well-rounded presentation of modern cost accounting concepts and practices. The book may be said to be both new and modern, for it presents not only material not previously found in cost texts; it also embodies many practices and procedures that are in the tradition of the post-war world we live in rather than the often outmoded ways of an earlier era.

Since this is primarily a textbook, the authors of necessity must cover the more or less familiar groundwork before discussing new material. In doing this they have presented basic procedures, but they have also introduced, so far as possible, the principles involved, cost control, and cost analysis. This is well illustrated, for example, in the case of the discussion of the Lifo method of costing and inventory valuation. The reason for Lifo, matching current costs against current revenue (cost principle) is given (p. 132); the basic method for carrying it out is then presented (cost procedure); difficulties of the method are then discussed, particularly from the viewpoint of the control of the cost figures and the analysis of the costs resulting from the application of various modifications of Lifo.

Altogether there are thirty chapters in the book, each complete with questions and problems. Of these, two chapters are in the form of student practice sets, one for job order costs (Chap. 12), the other for standard costs (Chap. 30). A third chapter (Chap. 22) is a demonstration of the application of standard costs and flexible budget techniques. The remaining chapters may be roughly grouped into three sections: (1) the basic

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BOOK REVIEWS

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material covering the nature of cost accounting, cost classifications, the manufacturing cycle, records kept; chapters on (2) material and (3) overhead. The discussion is then synthesized by presenting the principles of process costing (Chaps. 13-14), by-products, and joint products (Chap. 15), and estimated costs (Chap. 16).

The second portion of the book deals with modern costing procedures revolving around budgets (Chaps. 17-19), standard costs (Chaps. 20-22), and cost reports (Chap. 23). Chapter 24 on distribution costs covers the fairly conventional methods of cost analysis in that field.

The last portion is the most rewarding portion of the book. It embraces chapters 25 through 29 covering gross profit analysis, break-even analysis, profit-volume relationships, differential costs, and miscellaneous problems involving choices between alternative courses of action. It is this last portion of the text which makes it valuable, since it introduces in addition to direct costing methods the whole complex of problems with which the modern cost accountant must deal. It is these problems which have raised his position above that of a keeper of historical records and have firmly established him as a member of the top executive group, often referred to as the management team.

To be sure, the ideas presented in these chapters could be further elaborated upon. But a good beginning has been made. The discussion on differential costing has been kept on a practical level without being directed into theoretical economics.

Since this is the work of three authors, it must be said that a good job has been done in welding the work of three men into a single harmonious work of uniform texture. All too often such work is marred by the uneven presentation of men of different backgrounds. This is not the case here. Altogether this book is to be welcomed; it constitutes a serious, well-rounded, and mature discussion of modern cost accounting.

THEODORE LANG
Professor of Accounting
New York University
Graduate School of Business
Administration

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BOOK REVIEWS

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New York Laws Affecting Business Corporations (Annotated)

33rd Edition. Revised to April 20, 1952. xxxii + 683 pages (paper cover). Price: $2.50, postage prepaid.

This handy volume contains the General Corporation Law, the Stock Corporation Law, the General Associations Law, and selected provisions of the Membership Corporations Law, the Tax Law, the Personal Property Law and other Consolidated Laws relating to General Business Corporations. There is also included a synoptic analysis (which is a topical arrangement of corporate subjects and procedure wherein will be found a quick reference to the applicable statutes), a table of cases and a complete index.

The most important changes reflected in this edition affect paragraphs 9 and 12-a of the General Corporation Law, paragraph 71 of the Stock Corporation Law, paragraph 55 of the Membership Corporation Law, and paragraphs 510-514 of the Abandoned Property Law.

1951 Survey of New York Law

Contained in the December, 1951, issue of the New York University Law Review (Volume 26, Number 5), New York, N. Y.; pp. 745-1085, inclusive. $3.00.

This is the fifth volume in the annual series surveying New York Law. The work is divided into five parts:

1. Public Law: In General
2. Commercial Law
3. Property Law
4. Equity, Torts and Family Law
5. Adjective Law

As in the past, the sections dealing with State and Local Taxation, Trusts and Administration, and the Law of Succession will probably be of particular interest to practicing accountants. The part dealing with Commercial Law will also be helpful to them.

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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Rent Increase Grants Under the State Rent Control Law Based on Rental Income

By EMORY GARDINER, ESQ.

This paper discusses current procedures in the processing of applications for rent adjustments under the so-called "4% net annual return" provisions of the Emergency Housing Rent Control Law. It includes references to recent court decisions interpreting the statutory provisions. Since some of the problems discussed have not yet been finally adjudicated by appellate courts, it is suggested that the reader pursue further independent inquiry when such circumstance is indicated in the text.

THE Emergency Housing Rent Control Law, as presently enacted, authorizes the Administrator to grant individual increases in maximum rents of apartments or rooms in certain circumstances when the rental income is insufficient to meet specified statutory standards of adequacy. Different standards and conditions are stated for the following three classifications of housing accommodations:

1. The usual apartment house;
2. Housing owned by a "small landlord", i.e., when the landlord owns in all not more than four *apartments;*
3. Hotels, rooming houses and cooperatives.

While many legal problems are involved in determining the right of the landlord to an increase, accounting procedures, techniques and, especially, theories are the primary and controlling considerations. It may well be said to be an accountant's problem in its underlying aspects. An understanding of the law is therefore of vital interest.

EMORY GARDINER, ESQ., member of the New York Bar, is an Assistant Counsel to the State Rent Commission. He is co-author of "New York State Rent Control, 1951 Supplement." The views herein expressed are those of the author and do not reflect the position of any government agency or public officer.

This paper was delivered by Mr. Gardiner before the technical meeting of the Society held under the auspices of the Committee on Real Estate Accounting on May 8, 1952, at the Engineering Societies' Building in New York City.

1. Statutory Provisions and Background Matters

The Emergency Housing Rent Control Law, enacted as Chapter 250 of the Laws of 1950, was an amendment of an existing stand-by state rent control law, which thereby became a functioning and operative law. The legislative plan, in its broad aspect, was to have a stand-by law available on an emergency basis in the event federal rent controls were repealed or otherwise were rendered ineffective.

In 1950, the federal rent control law was amended to authorize any State, under conditions described in that law, to supplant federal control of rents with regulations of its own design. Our Legislature adopted the prerogative thus granted by the federal law and undertook to substitute a statewide rent control law.

As concerns the freezing of rents, under the state law, the underlying plan was to fix a ceiling on all rents as they were on March 1, 1950 (with an exception which is not relevant to this discussion). Rent increases of all sorts were expressly prohibited (with one minor exception, not pertinent to this discussion). However, the Legislature recognized that this emergency freezing of rents would result in some hardships to landlords and therefore provided in Section 4, subd. 1(b) of the law that the State Rent Administrator was to undertake a comprehensive survey of rental conditions in the State. The Administrator was required to promulgate regulations, not later than December 1, 1950, which would permit rent increases in categorical hardship cases. This was a temporary measure, pending submission to the Legislature, not later than January 15, 1951, of a comprehensive plan for granting rent increases to meet those conditions disclosed by the survey.

The Administrator's findings were collated in a report entitled "Survey of Rents" issued on November 1, 1950. On January 15, 1951, a further report, entitled "Rent Control Plan" was issued. This report, which contained the proposed comprehensive plan for granting rent adjustments was submitted to the Legislature. The plan, as incorporated in the proposed new regulations was adopted by the Legislature in a further amendment of the State Law (Laws of 1951, ch. 443).

This new law provides generally for seven classes of rental increases. Three of the provisions—those to which this discussion relates—are based essentially on the insufficiency of current rental income of a building. In order best to reach the conditions disclosed in the survey, the law, for these purposes, divides housing into three classes, with different requirements stated for each class.[1]

(a) The normal apartment houses, generally, will have maximum rents adjusted by order, if the net rental income is insufficient to provide a net annual return of four percent of the equalized assessed valuation of the property.

(b) Small landlords—by definition, those whose total property holdings in this state contain no more than four rental units—are treated separately. Because of the relative unimportance of this category, no further consideration will here be undertaken.

(c) Hotels, rooming houses and cooperative apartment houses comprise the third class. Maximum rents in such accommodations, generally, will be adjusted by order to offset any unavoidable increases in costs of operating the structure (including property taxes but not mortgage interest, amortization or depreciation and obsolescence allowances and reserves) which have occurred since the establishment of the ceiling rent under federal law (usually March 1, 1943), or the date when the present owner com-

[1] Emergency Housing Rent Control Law, sec. 4, subd. 4(a); Rent & Eviction Regulations, secs. 33(5), (6) and (7).

menced operations, but only to the extent that such increases have not been offset by increases in rental since that date.

The law also provides for an overriding limit to the increase of fifteen percent over the present rental, but only during the calendar year next succeeding the date of the issuance of the order.[2] Provision is also made that in allocating the increases among the different apartments or rooms, consideration shall be given to prior voluntary increases, among other things.[3]

The regulations issued by the Rent Administrator to cover this class of relief[4] are a substantial paraphrase of the law. In addition, however, the regulations define five basic terms, more fully describe the method of allocating among individual tenants of the total increase to be granted, and make provision for granting further increases at annual intervals.

After an over-all increase has been found to be warranted under the law, it will be allocated first to those tenants who had not previously given voluntary increases permitted under the law.[5] Since such voluntary increases were permitted up to the overriding limit of fifteen percent of the specific maximum rent, each tenant will thus be allotted a dollar and cents increase of *his* maximum rent, so that all tenants are brought into substantial parity as regards "percentage increases" without regard to the absolute dollar amount involved. In making this allocation, no weight is given to prior increases ordered on the basis of additional services or equipment which the landlord may have installed.[6]

Of course, such allocation is made only to the extent that no individual tenant's rent may be increased more than fifteen percent.

If all tenants have thus been placed on a relatively equal footing, and there is still an unexpended balance of the total increase, that remaining portion will be distributed equally, until it shall be fully expended, again with the condition that any individual increase is limited to fifteen percent. It should be noted that as the over-all increase allowed the landlord approaches fifteen percent of the rental income, tenants who may have previously given a voluntary fifteen percent increase may nevertheless be taxed with an additional increase (approaching 15%); even those tenants who were less generous in their dealings with the landlord will now be increased by not more than fifteen percent.

If under such allocation each tenant's rent is increased by a full fifteen percent and the indicated over-all increase is not yet fully allotted, that unexpended balance is simply disregarded. The landlord may apply again at any time for an additional increase but the increase will not be made effective until one calendar year after the date of the original order.[7]

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2 Emergency Housing Rent Control Law, sec. 4, subd. 4(b).

3 Id., sec. 4, subd. 4(c).

4 See note 1.

5 See Emergency Housing Rent Control Law, sec. 4, subd. 4(a); Rent & Eviction Regulations, sec. 33(2).

6 See Emergency Housing Rent Control Law, sec. 4, subd. 4(a)(5); Rent & Eviction Regulations, sec. 33(1).

7 Rent and Eviction Regulations, Amendment 8, issued February 1, 1952. A question arises as to the effective date of the order granting the increase where such increase was originally denied, in whole or in part, but was later granted after a review in the courts. In some instances the Administrator has admitted error in denying the increase. The legal problem is as to the effective date of the order granting the increase (especially when error is acknowledged) bearing in mind that the law prohibits any retroactive increase in rents. The problem was collaterally answered in *Levy* v. *1165 Park Ave. Corp.*, 127, NYLS 1914, May 13, 1952, Sup. Ct. N. Y. Co., where the Supreme Court held that the final order dated back the date of the one incorrectly issued. The Administrator was not a party to that action. The point of law is directly involved in *Matter of Interborough Leasing Corp.* v. *McGoldrick*, presently pending undetermined in the Supreme Court, New York County.

2. The Administrative Technique for Processing Applications

The administrative proceeding to obtain such increase in rents is begun by an application prepared by the landlord. Necessary blank forms are available at the local Rent Office of the State Rent Commission. Detailed instructions for preparation of the forms are contained in Bulletin 7a (for Apartment Houses) and Bulletin 11 (for Hotels, etc.), also available at the local Rent Office. These instructions will presently be discussed.

The application with required copies is filed in the local Rent Office. A preliminary audit is there made which involves to a great extent, the determination of sufficiency as to form. Tenants are notified by the Commission of the pendency of the application. At this point the most important consideration is whether the landlord is presently maintaining required services in the building. As a condition precedent to granting any increase, the law provides that the landlord must certify that he is presently maintaining all services required by law.[8]

After such notification to the tenants, they may file answers within seven days and they frequently do, alleging that various essential services, such as, painting, repairing, garbage collection, doorman, elevator service, among many others, are not being maintained. Not infrequently, a conference is held at which landlord and tenants may appear, represented by counsel. Invariably, if the tenant's complaints are sustained, the landlord will be required to make written committments to make specified repairs.[9]

In the meantime, the application and required schedules are transferred to the Accounting Section of the State Rent Commission at 280 Broadway, New York, N. Y., for auditing.[10] The landlord will be notified to produce records and other necessary data to justify the schedules submitted with the application. Tenants are not given notice of this hearing nor do they participate.[11] In theory and practice the Rent Commission verifies the accuracy of the landlord's claims.

At this conference (the Commission's examiner will be an accountant) the schedules, as submitted, will be adjusted, either in final form or along lines generally indicated by the examiner. The final adjustment will appear on a form called "Accountant's Work Summary."

If this audit indicates that an adjustment of rents is required, the examiner will prepare a "Rent Allocation form", based on data as to present maximum rents received from the local Rent Office. This analysis, when completed, is returned to the local Rent Office, which then issues orders increasing rents as directed or denying the application.

Either landord or tenant may appeal from such an order by filing a Protest within 30 days.[12] In the course of determination of this Protest, a reaudit is made by the Acccounting Section, this time by accountants of a higher echelon. An order is finally issued by the Administrator, either sustaining the local Rent Administrator's order or varying it as required.

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[8] Emergency Housing Rent Control Law, sec. 4, subd. 4(d); Rent and Eviction Regulations, sec. 33. See, also, Regulations, sec. 23.

[9] In *Matter of Amson* v. *McGoldrick*, 127 NYLS 2095, May 26, 1952, Sup. Ct. N. Y. County, the court held that no order granting the increase may properly be issued until the landlord has in fact complied with such committments.

[10] This procedure is applicable to all of the City of New York and generally to Westchester County. Elsewhere in the state, personnel of the Accounting Section travel periodically to the various local Rent Offices.

[11] This procedure was approved by the Court in *Matter of Amson* v. *McGoldrick*, *supra*.

[12] Emergency Housing Rent Control Law, sec. 8; Rent and Eviction Regulations, secs. 91-104.

Either landlord or tenant may seek review of this order in the Supreme Court.[13] The Commission's order is now considered by the attorneys of the Commission in the Litigation Section. To the extent that accounting problems are involved, the matter is again reviewed by the Accounting Section. If, as sometimes happens, the action of the Commission is believed by them to be erroneous, they will request the Supreme Court to remit the proceeding for corrective administrative action. However, as is most often the case, the Commission will uphold its views in court. It might be said in passing, that in an overwhelming proportion of its cases, its action has been upheld by the courts.

3. The Regulatory Plan Covering Increases in Apartment Houses[14]

The landlord is required to select a test year, which may be the most recent full calendar or fiscal year or any twelve consecutive months ending not more than 90 days before the filing of the application.[15]

Rental income for this test year is stated to include rental from controlled units, from decontrolled units, from commercial units and vacant or rent free units. The latter two items are set forth at the normal occupancy rental.[16] Income from all other sources, such as phones, washing machines, maid service, etc., is also included.

The total rental income thus calculated is compared with the operating cost during the test year. Such costs are intended to reveal the normal recurring costs of operating the structure. Costs incurred during the test year but which because of some unique or peculiar circumstance do not truly reflect a normal recurring operation will be disregarded. The general circumstances under which this will be done will be discussed presently when the separate scheduled classification of costs will be considered.

Depreciation of the building, only, is allowed as a cost to the extent of the lesser of the amount claimed in the last federal income tax return or two percent of the equalized assessed valuation of the building.

The difference between the total rental income and the costs thus calculated is the net annual return during the test year. Any deficiency between this amount and the amount equal to four percent of the equalized assessed valuation of the property, is the amount of the indicated total annual increase in rents.

4. Calculating Operating Costs

a. Fuel

Fuel costs are set up in prescribed detail in a schedule indicated as "C". No adjustment is made for inventory. However, if the invoices indicate heavy purchases in the closing days of the test year, whatever the reason may have been, the Administrator will disregard the schedule, finding it not to be an accurate index of annual recurring fuel costs. He will substitute some other figure, such as average annual consumption for a period of years, calculated at average cost during the test year.[17]

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[13] Emergency Housing Rent Control Law, sec. 9; Rent and Eviction Regulations, sec. 103.

[14] Advisory Bulletin 7A, revised April 1, 1952, contains detailed instructions for preparing the necessary application and schedules.

[15] The court has held that a purchaser may succeed to the pending application filed by the seller. *Matter of Amson* v. *McGoldrick, supra.*

[16] While the propriety of including rental value of vacant apartments has never been directly tested in the courts, in *Matter of Tri Reme Realty, Inc.* v. *McGoldrick,* 126 NYLJ 975, Oct. 24, 1951, Sup. Ct., Nassau Co., it was indicated by the court that in a subsequent annual application, loss of income from vacant apartments could be set up as an item of "overhead" presumably under the "Miscellaneous" schedule.

[17] Such action was upheld by the court in *Matter of 170 Parkside Ave. Co.* v. *McGoldrick,* 127 NYLJ 514, February 6, 1952, Sup. Ct., Kings Cty.

b. Utilities

Costs for public utilities are set up in prescribed detail in a schedule indicated as "D". Included therein are gas, electricity, telephone, water if privately supplied, and other similar charges.

c. Payroll and Related Costs.

Payroll, Workmen's Compensation Premiums, Social Security Taxes, Welfare Plan and similar costs connected with payroll charges are set up in prescribed detail in a schedule indicated as "E". The Commission's policy is not to allow the bookkeeper's salary as a payroll cost but rather as an item of mangement cost. This is significant because management costs are allowed to a prescribed limit (*infra*) so that transferring items to that schedule frequently has the effect of disallowing them. An allowance for janitor's wages may be taken to the extent of $4.00 a month for each apartment, with an absolute limit of $50 a month.

d. Real Estate Taxes

Regardless of the amount of such taxes paid during the test year, if a current tax bill is available when the application is filed (or even at the audit in the Accounting Section), such current taxes may be projected. The tax bill must be attached to the required schedule (F).

In a unique circumstance to be considered presently, the actual assessed value of the land is not used as the basis for determinating the permissive statutory return. In that case, the actual taxes paid are nevertheless, used as the item of operating cost.

e. Insurance

These charges are set up in prescribed detail in a schedule indicated as "G".

f. Management

Allowance of management cost is ordinarily made in an amount determined by customary practices in the community. In New York City, the rates are those established by the Real Estate Board of New York.

When the property is managed by a recognized management firm, the commission paid will normally include two items:—(1) a charge for operating service and (2) a charge for leasing service. When the building is owner-managed an allowance for management, determined in the same manner, will be made, except that any charge for leasing service will be allowed only if such charge is set up in the owner's books as an expense *and* the owner is a licensed real estate broker. If a leasing commission is actually paid, it will normally be allowed.

General office expenses, officers' salaries, and other incidental expenses directly connected with management will be included in this allowance, and, of course, the final amount is subject to the limit established by local real estate practices.

g. Repairs and Maintenance

The Commission's instructions (Advisory Bulletin No. 7A, Instruction 17) require that schedules of repair and maintenance costs be submitted for four successive years including the test year. The average of these four years is the figure used in the final calculation of operating costs.

The requirement that repair and maintenance costs (and none other) be averaged during a four-year period is aimed at obtaining a more accurate index of the annual recurring expense for these purposes. This type of servicing is not repetitive, on an annual basis and therefore averaging costs is more likely to lead to a just result.[18]

[18] This reasoning has been upheld in *Matter of Stevens*, 127 NYLJ 432, January 31, 1951, Sup. Ct., Queens Cty., and *Matter of Wasmil Realty Corp.*, 127 NYLJ 1059, Mar. 17, 1952, Sup. Ct., N. Y. County, affirmed in the Appellate Division, 127 NYLJ 2225, June 4, 1952.

The problem has arisen as to what procedures are to be taken when for various reasons a landlord does not have figures available for the required period or if available are, for unique reasons, clearly not representative of the normal recurring annual expense. Two reported cases, in which the Administrator's technique was upheld, by the court, will serve to illustrate the underlying method for reaching such a circumstance.

In Matter of Stevens, supra, a two family house was involved. The application for rent increases was made under Sec. 33(5) of the Regulations, instead of Sec. 33(6), because the landlord owned other properties which removed him from the regulatory classification as a "small landlord." He submitted a detailed statement of repairs and maintenance items, all of which had been physically done by himself. He specified the hours (and fractions thereof) spent in doing that work and calculated total cost at $1.50 an hour. He justified this cost by reference to prevailing charges on the open market. The Administrator rejected this schedule and noted that the landlord was claiming such an allowance to an extent of about 56% of the annual rental income. The Administrator further noted that in a survey of almost 2,000 buildings in the city of New York, involving approximately 40,000 rental units,[19] the average amount expended for such servicing was only 11.9% of the annual rent roll. The Administrator found that the landlord's estimate was obviously inaccurate and therefore allowed the landlord a sum equal to 11.9% of the annual rental income. This he found to be a more accurate index of the normal recurring annual cost of this item.

In *Matter of Wasmil Realty Corp.,* see footnote 18, the landlord submitted a schedule for repairs and maintenance which included the only year of his operation (the test year) and the prior year and a half during which the building was operated by a receiver in foreclosure and an insurance company which was the foreclosing mortgagee. No figures were available for prior operations. The Administrator rejected the landlord's schedule and noted that the landlord's expense for this item during the test year was only one-seventh of that of the prior year's operation by the insurance company. Finding that the unusual factors involved in operations during foreclosure would not reflect the normal recurring annual expense, the Administrator substituted the 11.9% figure already described. His action was upheld by the Supreme Court and again by the Appellate Division.[20]

When the landlord has been the owner for the entire four year period but does not have the necessary records available, through carelessness or otherwise, the Commission usually requires him to reconstruct his records. Allowances will be made to the extent that such reconstructed records are acceptable.[21]

Repairs and maintenance charges furnish the area in which most adjustments are made by the Commission. Quite frequently the landlord's accounting reports include items of repair and maintenance which the Commission views to be a replacement or improvement. The effect of such an adjustment is readily apparent, for in

[19] Table 129, Survey of Rents, issued by the Commission on November 1, 1950.

[20] The landlord argued, among other things, that while the receiver and the insurance company may have spent unusual amounts for repairs, that fact was reflected in the high purchase price which he was required to pay and, therefore, he should be credited with such expenses.

[21] *In Matter of Warneke,* not officially reported, Supreme Court, Westchester Co., the Commission used a 14.2% figure (established by that survey as applicable to the state outside of New York City), because the landlord had owned the building for only 16 months and did not have prior operating figures available.

the latter category the item in question is amortized on a 15- to 20-year basis, whereas in the former it is weighted at ¼ of its face amount.

Generally speaking, the Commission will consider any item as a replacement or improvement if a substantial amount of new material has been incorporated into the structure in the course of the work. Generally too, if the item in question involves an accretion in the rental value of the structure, it will be deemed an improvement and not maintenance or repair. Thus, sandblasting, pointing, relaying sidewalks, replacing worn parts of staircases or fences have all been held to be replacements and improvements and not maintenance and repairs.

Not infrequently, the landlord will find that the Commission will view such expenses differently from the position taken by accounting firms with a recognized real estate specialty.[22] In this connection it must be emphasized that the Commission is given broad powers to pass rules, regulations and operating procedures in order that the legislative intent in enacting the law, may be realized. Within this framework, it may well be that the Administrator is not bound by such accounting procedures. In an analogous situation, the Administrator is authorized, in its administrative hearings to take and consider proofs which would not be admissible in a court of law. Hearsay proof may be taken. Terms of a lease may be varied by oral statements, notwithstanding the usual clause that the written lease constitutes the entire agreement.

It should be pointed out, however, that much, if not all, of the downward adjustment in total amount claimed for repairs and maintenance can be recouped if the landlord requests leave to submit an amended Schedule of Replacements and Improvements. The amendments should pick up all items similar to those eliminated by the Commission from the Schedule of Repairs and Maintenance, which occurred in the years previous to the "four-year period." In this way benefit will be derived from the unamortized cost of items which the landlord has been carrying as a repair, but which the Commission allows as a long-term improvement or replacement. As will be explained, *infra,* such items are limited to those incurring subsequent to March 1, 1943 (the federal freeze date) or the date of acquiring the property, whichever is later.

h. Replacements and Improvements

Costs of replacements and improvements made since the federal maximum rent date (usually March 1, 1943) or the date when the property was acquired by the present owner, whichever is later, must be apportioned in accordance with tables set out in Bulletin "F", issued by the United States Treasury Department.

We have already indicated how an amendment of this schedule can be made to include items which the landlord's accounting procedures have always considered to be repairs, but which may be adjusted by the Commission's auditors as constituting items of replacement and improvements.

i. Miscellaneous

Direct operational costs during the test year, not elsewhere particularized, should be set out in this schedule. Such items usually include: exterminating expenses, uniform upkeep, license fees, some association dues, some legal fees, etc. No expense directly connected with mortgage or amortization may be included.

j. Depreciation

Depreciation is allowed as an item of cost to an extent equal to two percent of the equalized assessed valuation of the building or the amount claimed

[22] There is a long line of cases in our appellate courts, which discuss the meaning of repairs, improvements, maintenance and so forth, as applied to certiorari proceedings in tax reduction cases.

as depreciation in the latest required federal income tax return, whichever is the lower. It follows that a building which, for federal income tax purposes has been fully depreciated will not be subject to an allowance for depreciation in this application.

5. Assesed Valuation

The underlying statutory plan, somewhat different from analagous provisions of the Commercial Rent Laws, is to provide a minimum net return to a landlord, which can be determined from a readily calculable base of value of the property. The equalized assessed value was selected because, in the normal case it is an exact figure which suitably establishes value for this purpose. The statute recognizes four instances when such a conclusion does not apply and authorizes the Administrator to accept some other index of value. These four cases are:

1. When there is a disproportion between the assessed value of the land and buildings. This would usually be the case when land is poorly developed or underdeveloped, or obsolescence has become a controlling factor. In each case, the rental value, from the tenant's view, is not fairly reflected by the total assessed value.
2. When an application for reduction in assessment is pending.[23]
3. When the assessment has been reduced during the year next preceding March 15, 1951.
4. When there has been a sale of the property during the year next preceding March 15, 1951, for an amount *different* from the assessment.[24]

It should be noted that the statute does not expressly provide what other index of value shall be used in these cases. It merely provides that the Administrator may reject the assessed value and substitute another.[25] Administrator's Opinion No. 85 was issued on December 1, 1951, to lay down the general procedures in cases where assessed value would be rejected. This opinion dealt mainly with considerations involved in determining value of the property in "disproportion" cases. The broad rule enunciated was that value would be established at five times the annual rent roll or four times the assessed value of the building whichever is the higher. In *Matter of Blackport Estates, Inc.*, v. *McGoldrick*, 127 NYLJ 2432, June 19, 1952, the Appellate Division held this method to be invalid. The court said that while the Administrator was authorized under the law to reject the assessed value in "disproportion" cases, he nevertheless could not establish value on the basis stated in Administrator's Opinion No. 85 because that method was arbitrary. The court indicated that the Administrator was required to establish value as otherwise provided by law. The

[23] Even when the two successive applications for reduction are pending undetermined, the Administrator may properly accept the assessed value until finally acted on by the courts. If the assessment is reduced significantly, the tenants may then apply to the Administrator to review his determination in the light of that change. *Matter of Roe*, 127 NYLJ 1769, May 2, 1952, Sup. Ct., Bronx Cty.

[24] If the sale occurred even two months after the year thus specified, even though the sales price was one-third less than the assessed value, the Administrator was required by law to accept the latter figure. And depreciation was properly calculated on the assessed value of the building. *Matter of Amson, supra.*

[25] *In Matter of Abrams*, 127 NYLJ 1638, Apr. 24, 1952, Sup. Ct., N. Y., the Administrator accepted the assessed valuation of the property even though the assessment had been reduced the year previous as a result of court proceedings. This action was sought to be justified on the ground that if the net return were calculated on the reduced assessment, the landlord would not realize enough to pay interest on the mortgage after expenses. The court held that such action by the Administrator was contrary to law. An appeal by the Administrator is pending.

Commission is appealing the decision to the Court of Appeals.

Some hint as to the method of evaluation which must be used in such cases is found in *Kimmel* v. *McGoldrick*, 127 NYLJ 2226, June 4, 1952, Sup. Ct. N. Y. County, in which Mr. Justice Hecht refers to *Heiman* v. *Bishop, 272* N.Y. 83, as stating proper procedures in evaluation cases. This case generally discusses all of the elements involved in evaluating real estate in certiorari proceedings in the Supreme Court to reduce assessed value. This determination of Mr. Justice Hecht is significant because the Appellate Division cited it with approval in the *Blackport* opinion, *supra*. The Commission is appealing the *Kimmel* case.

6. Increases in Hotels, Rooming Houses and Cooperative Buildings[26]

Rent control in hotels has the distinguishing feature that it is the individual tenant who is the subject of control and not the particular apartment as in the case of apartment houses, rooming houses and other accommodations. A person who has lived continuously for 90 days in a hotel since December 2, 1949, is called a controlled tenant and receives the benefits of the law, as do no other tenants of the hotel. When the controlled tenant moves from one room to another, the former room automatically is free of control though the tenant is still protected by the law, in the new room. This is an all important factor in the full understanding of the hotel rent increase problem.

These classes of housing are treated differently, under the law, from apartment houses. A different basic formula is provided for the granting of over-all increases to the landlord (properly allocated among the controlled tenants). Generally, the formula is that the landlord will be granted an over-all increase if he has incurred unavoidable increases in property taxes and other operating costs (but excluding amortization, interest, depreciation, obsolescence and reserves) which have occurred since the date as of which the maximum rent was determined under federal law (or the date when this landlord commenced operations, whichever is later) to the extent that such increased operating costs have not been offset by increased rental income.

Operating costs, classified in seven categories, are submitted by the landlord for the base and the test years. A factor known as the "controlled ratio" is determined by averaging (1) the percentage of all rooms in the hotel occupied by controlled tenants with (2) the percentage of all units in the hotel occupied by controlled tenants. The "controlled ratio" is applied to the increase in operating costs, established in the manner already discussed, and the result is the portion of the increase in such costs, allocable to controlled tenants. There is then set-off against this allocable share of the increase, all rent increases which the landlord has obtained from *controlled tenants* since the base year. The difference is the indicated amount of over-all annual increase required. This figure is, of course, limited to fifteen percent of the current maximum rents of controlled tenants.

This method of calculation was held invalid by the court, in *Matter of Markens* v. *McGoldrick*, 127 NYLJ 2095, May 26, 1952, Sup. Ct., N. Y. County, and a companion case *Matter of Robinson* v. *McGoldrick*, same citation.[27] The court found that the law required that *all* increased rental income be offset against increased costs and not simply increase rental income from controlled tenants, as is being done by the Com-

(Continued on page 537)

[26] We will discuss this problem only as it applies to hotels.

[27] On July 17, 1952, this proposition was again argued in the Supreme Court, N. Y. Co., in three cases entitled *Matter of Katzenstein* v. *McGoldrick*, *Matter of Billingslea* v. *McGoldrick and Matter of Donohue* v. *McGoldrick*. At the date of publication, these cases have not yet been determined.

Recent Amendments to the Commercial and Business Space Rent Control Laws

By Anthony Curreri, Esq.

This paper explains the various amendments to the Commercial and Business Space Rent Control Laws which were enacted by the 1952 State Legislature. It also discusses their impact upon the relationship beween landlords of commercial and business properties and their tenants.

At the 1952 session of the New York State Legislature numerous amendments were made to the commercial and business space rent control laws upon the recommendation of the New York State Temporary Commission* to study rents and rental conditions. The report of the Commission is contained in Legislative Document (1952) No. 61. The amendments were enacted into law by Laws of 1952, Chapters 416 and 417, effective April 3, 1952.

Without exception, each of the amendments made moves along the road in the direction of eventual decontrol of commercial and business properties. This is in line with the legislative mandate imposed upon the Commission to inquire into the need for the gradual discontinuance of the rent control laws. Parenthetically, it may be observed that no amendments to the Emergency Residence Rent Control Law were recommended or made.

In the discussion of the amendments to the business and commercial rent control laws which follows, the amendments are not necessarily set forth in the order of their importance. The purpose of this paper is to explain these amendments and discuss their impact upon the relationship between the landlords of commercial and business properties and their tenants.

(1)

Excluded from the definition of "service" contained in both laws is the "sale of electricity, live steam, or any other item for which a separate charge is made by the landlord." Since this is no longer a necessary service, where such service is discontinued, the tenant may no longer obtain injunctive relief commanding the restoration of such service or defend an action or summary proceeding for non-payment of rent by reason of such discontinuance. Moreover, in a proceeding by a landlord to fix a reasonable rent in excess of the emergency rent, it appears that income from the sale of electricity, etc., for which a separate charge is made, will

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This paper is an amplification of the address made by Mr. Curreri before the technical meeting of the Society held under the auspices of the Committee on Real Estate Accounting on May 8, 1952, at the Engineering Societies' Building in New York City.

* Not to be confused with the New York State Temporary Housing Rent Commission, which administers *residential* rent control.

no longer be considered as part of the rental income from the building.

(2)

By reason of the fact that in midtown Manhattan the Commission found residential buildings being converted to business use, the legislature decided to define as business space a building in which at least 60% of the total rentable area and 60% of the total number of units formerly used as dwelling space is lawfully occupied as business space on and after March 1, 1952.

This amendment will probably give rise to many serious problems. For example, if such a building is deemed to be a business building, what will be the status of the remaining residential tenants? Will they be occupying business space, and if so, how will the emergency rent for such space be fixed? Will they be protected in their possession by the provisions of the Residence Control Law or by those of the Business Rent Control Law? Is the amendment intended to cover buildings in which the 60% requirements come into being for the first time *after* March 1, 1952? Lastly, the liberal application of this section would affect, for example, a 3-story building originally completely occupied as a residential building where, at some time prior to March 1, 1952, the ground and first floors were converted to business use for professional purposes. As of this writing the author knows of no pending judicial proceedings in which these problems have been raised.

(3)

In a Section 4 (1) proceeding where the landlord is seeking to fix a reasonable rent in excess of the emergency rent by reason of an actual over-all return below the statutory rate of 8%, the legislature has decided that where the Court makes a determination of such reasonable rent, tenants who are parties to the proceeding are liable for the increase back to the day when the application for the increase was originally made. This amendment resolves the conflict caused by some Courts awarding the increase prospectively from the date of decision only.

(4)

In a Section 4 (2) proceeding where the landlord is seeking a fixation of reasonable rent in excess of the emergency rent based upon the relative rental value of the space occupied by the tenant, the landlord was heretofore limited to an increase of 15% above the emergency rent in any one year. The effect of this limitation was to require a landlord to institute successive proceedings in those cases where originally the Court had found that the reasonable rent was more than 15% above the emergency rent.

The recent amendment continues the limitation of 15% in any one year but permits automatic increases of 15% per annum above the original emergency rent until the new emergency rent becomes equal to the rent fixed by the Court.

(5)

Upon the expiration of any type of lease or rental agreement, whether the lease be a graduated lease, a percentage lease, or a straight lease, the law now permits the landlord and tenant to enter into an agreement fixing a reasonable rent in excess of the emergency rent. Such agreement, must, of course, meet the statutory requirements that it contain a statement (1) of the emergency rent, (2) advising the tenant of his right to continue in possession upon payment of the emergency rent, and (3) permitting the tenant to cancel the agreement within 60 days after its execution.

(6)

Under the business and commercial rent control laws, a landlord may evict a tenant where he seeks, in good faith, to recover possession for the purpose of demolishing the building and constructing a new building. The Commission found that in many cases this intention of the landlord was frustrated by the system of priorities contained in the

National Defense Act by reason of which the landlord could not obtain materials for the construction of the new building, and, therefore, could not show a right to possession.

Consequently, a new section was added to both laws which permits a landlord to recover possession for the purpose of demolishing a building and constructing a new building, despite the fact that the construction of the new building is prohibited or delayed by inability to obtain priorities. This section further provides that until such a new construction is possible the landlord is permitted to use the cleared land as a parking lot.

It occurs to the author that if the zoning ordinances of the City of New York prohibit the use of a particular parcel for parking lot purposes, a serious question will arise as to whether or not this amendment conflicts with or is intended to override the provisions of the Zoning Ordinance of the City of New York. Certainly any landlord who intends to avail himself of the benefits of this new ground for eviction ought first to determine whether or not the Zoning Ordinances of the City of New York permit the use of the land involved as a parking lot.

(7)

Hitherto a landlord who had acquired commercial or business property after January 24, 1945, and who sought possession of space in such a building for his own immediate use and occupancy was required to show an equity in the property purchased equal to 25% of the purchase price. He is now required to show an equity of only 20%.

(8)

Under the provisions of the commercial and business rent control laws, as amended, a landlord may serve a demand upon the tenant by registered mail that he renew his lease for the same or shorter term at the landlord's option, at a rent not in excess of the emergency rent. Where the lease demanded to be renewed has not yet expired, the tenant is required to agree to execute such renewal not more than 12 months and not less than 6 months prior to the date upon which the lease expires. It follows, therefore, that in such case that demand must be made at least 6 months before the lease expires. Where the tenant is in possession as a statutory tenant after the lease has expired, the landlord may demand the renewal at any time and the tenant is required to execute it within 30 days after receipt of the demand. In either case, if the tenant refuses to execute such renewal he may be evicted.

This new amendment gives a landlord the power to recreate leasehold tenancies in place of statutory tenancies, in those cases where statutory tenants were once in possession under written leases. Furthermore, the rent reserved in the new lease may well be in excess of the rent reserved in the original written lease since it is the emergency rent which the landlord may demand.

(9)

A very important addition to the law affecting the rights of business and commercial tenants is contained in the amendment which now provides that if a tenant vacates premises without giving the landlord 30 days written notice by registered mail of his intention to vacate, he will be liable to the landlord for an additional month's rent. This requirement applies to any tenant who is in possession as a monthly or statutory tenant. Until this change was added to the law, such a tenant could move out on the last day of the period for which he had paid rent without incurring any liability whatsoever to his landlord.

(10)

Coupled with the foregoing addition to the Business and Commercial Rent Control Laws is a new provision that if a tenant notifies the landlord in writing of his intention to vacate the premises at a date certain in the future (which obviously he must do in order to avoid liability for the additional month's rent

as above set forth) and does not so vacate, he may be evicted for failure to deliver possession. Moreover in such case the Court in which the summary proceeding is brought may not stay the issuance of a warrant of eviction for a period longer than two months.

(11)

The provisions of the Business and Commercial Rent Control Laws dealing with store premises were the subject of extensive modification. Prior to the amendments made by the 1952 Legislature, a landlord could evict a statutory tenant of store premises who refused to match a bona-fide ten year non-cancellable lease offered by a prospective tenant where the rent reserved was $6,000 or more. The modifications have affected the following changes:

(a) The word "store" for the purposes of this particular section of the law is defined as any commercial or business space at street level and two floors above and below street level or any part thereof, provided some space at store level is included, which is used or intended to be used for the sale of personal property or the rendition of services. This includes wholesale as well as retail businesses.

(b) Where the particular store space affected is occupied entirely by one tenant, the rent reserved in the prospective ten-year lease need not be more than $4,800 per annum.

(c) Said ten-year lease is not to be deemed cancellable merely because it contains a provision that the lease shall have no effect if possesion is not delivered within one year after execution. However, where the landlord proceeds against the statutory tenant to evict him because of his refusal to execute a "matching" lease, the Court is not authorized to issue a warrant of eviction unless and until satisfactory evidence is produced that this election to cancel has not be exercised.

(d) In the case where the space affected consists of space occupied by more than one tenant, or of space partly vacant and partly occupied by at least one tenant, and the landlord is able to obtain a ten-year lease for such entire space at an annual rental of $10,000 or more, the landlord is not required to give the tenant or tenants in possession an opportunity to match the lease; he may proceed to evict without so doing.

(e) Where a final order awarding possession is granted under this subdivision, the Court in which the summary proceeding is brought may not stay the issuance of a warrant of execution for a period exceeding three months.

(12)

The recent amendments extend to all persons entitled to possession of real property under the provisions of the Commercial and Business Rent Control Laws the right to maintain and prosecute summary proceedings in order to obtain such possession. The effect of this amendment is to circumvent a decision in the Appellate Division, First Department, wherein it had been held that one who becomes a 21-year lessee of an entire building may not institute summary proceedings against a statutory tenant of the owner, but is instead relegated to the common law remedy of ejectment.

(13)

Last year the Court of Appeals held that a release given by a statutory tenant in settlement of a cause of action which had arisen in his favor under the Commercial and Business Rent Control Laws was invalid, though given for a valid consideration, because it violated the public policy expressed in the statute prohibiting any waiver of the benefits of the laws by a tenant. This decision therefore effectively operated to nullify any attempt at settlement of an action arising out of the Commercial and Business Rent Control Laws. Consequently the 1952 Legislature added to these laws a provision that a release by a tenant in writing and for a valid consideration was not

to be deemed to be a waiver of the provisions of said laws.

(14)

That part of the Commercial and Business Rent Control Laws which decontrols vacant space was tightened up. Space now vacant or hereafter vacated by a commercial or business tenant, or space which is leased under a lease executed after March 31, 1950, to a person not in possession at the time of the execution of the lease, is de-controlled.

(15)

In any case where the landlord and tenant have submitted to arbitration with respect to a controversy arising out of the rent laws, a proceeding to set aside the arbitrator's award must be begun within three months after the award is made. The former provision that the proceeding be taken within 90 days was changed in order to conform the Rent Laws to the provisions dealing with arbitration contained in the Civil Practice Act.

(16)

Added to the Business and Commercial Rent Control Laws is an amendment which de-controls any commercial or business space in a building which has been or hereafter shall be taken in condemnation. Thus, statutory business tenants in a site taken in condemnation by the New York City Housing Authority, for example, will no longer be protected by the Rent Control Laws.

Conclusion

It was pointed out at the beginning of this article that the amendments made by the 1952 Legislature, without exception, favor the landlord. The truth of this statement should be apparent even to the most casual reader of the above exposition. Barring unforeseeable changes in the economic and international situations, it is fairly predictable that the ensuing years will bring a gradual, perhaps a sudden, relinquishment of rent controls by the State of New York, at least in the field of business and commercial rent control.

Rent Increase Grants Under the State Control Law Based on Rental Income

(Continued from page 532)

mission. The court therefore held that Amendment No. 7 to the Rent and Eviction Regulations, promulgated on November 1, 1951, which expressly authorizes the calculations as undertaken by the Administrator, to be invalid because it is contrary to the statute. The State Rent Commission has filed a notice of appeal. Since by law, the effect of the court's determination is stayed pending appeal, the Commission presumably will continue to process hotel cases as before.

Conclusion

No effort has been made to discuss numerous complicated legal issues involved in the construction of this law. Many of these problems have already been tentatively decided by the courts. We have attempted merely to reach those areas of this law which present problems, essentially accounting, in nature. It is hoped, by this discussion, to alert the accounting practitioner to the nature of the problem in order that he may, more effectively, perform his professional duties.

Taking the CPA Examination

By ALDEN C. SMITH, C.P.A.

A member of the Board of CPA Examiners points out, by discussing illustrative answers, some of the reasons for the failure of candidates in the CPA examinations. He concludes by making specific recommendations for the improvement of answers, with particular reference to the Accounting Problems part of the examination.

The Viewpoint of the Examiner

Before referring to specific questions and answers, I want to ask you to keep in mind the examiner who grades your paper. He is a C.P.A., possibly with long years of experience. He is a professional man; he has read the Rules of Professional Conduct and he believes in the ethics of the profession. He is also a human being like you and me, subject to the same human frailties, and he has his peculiarities. His task is to grade the papers of a good many candidates, and I am sure that he approaches the work conscientiously and with a desire to be fair. However, the grading of examination papers is never a pleasant task and, as the day wears on, it becomes even more difficult. Consequently, illegible hand-writing, sloppy papers, flippant phrases and evasive answers can only tend to irritate an examiner. It is up to you candidates to attempt to keep him in a proper frame of mind if you want to get the best grades. Try to put yourself in his place and do not always expect him to put himself in your place. You can be assured that he will be much more apt to do that than *vice versa*, as he has had to suffer through the examination in some previous year. In discussing the position of the examiner with one of the recent candidates, the latter stated that actually there was no reason for the examiner to consider the candidates as school children, that those taking the exam had had four years of college education and experience in writing exams, and that they should realize the importance of what they are doing.

The examples illustrating points that I wish to bring to your attention were mainly chosen from papers from the November, 1951, Theory examination which were on the borderline, those where four or five points would make the difference between passing and failing. It would be easy enough to pick ridiculous answers from papers with grades of 20, 30 and 40%. I have not done that. Neither have I included specific examples from other parts of the examination, as my discussions with other members of the board have indicated that they point up the same mistakes.

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This paper was presented by Mr. Smith at a joint meeting of the New York State Board of CPA Examiners and The New York State Society of CPAs, held on April 17, 1952, at The Manhattan Center in New York City.

Discussion of Illustrative (Poor) Answers

It will be easier for you to follow my comments if you pay close attention to the questions given in the examination, which I shall read to you.

Question No. 1 was as follows:

"In selecting a basis for pricing inventories, accountants have as one important objective the proper determination of income by matching appropriate cost against revenue. Does the pricing of inventories at 'cost or market—whichever is lower' conflict with that objective? Discuss fully, including consideration of the effect of the 'cost or market' rule on the usefulness of income statements and balance-sheets."

One of the candidates, in answering this question, stated that the effect of the cost-or-market rule on the balance sheet is to attempt to give a conservative value to the item on the balance sheet and not to include profits or losses as a *capital* item. He went on further to say, and I quote, "It is also an attempt to value inventories at a conservative value." We cannot quarrel with a statement that it is an attempt to give a conservative value, but what did the candidate mean by the statement that it is an attempt not to include profits or losses as a capital item? Did he mean that inventories are capital items and should not include profits or losses, or was he badly confused? This may have been an unfortunate use of a word, but you cannot expect the examiner to read your mind. Do not be careless with your choice of words. Use two, if one isn't sufficient to convey your thoughts.

Another candidate, in answering this question, stated, "The effect on the balance sheet will be that if inventory is moved from cost to market, whichever is lower, the total of current assets will be continually changing because of the change in the pricing of inventory. If a reserve is set up for future losses, it will be set up out of a charge to surplus and will be shown on the liability side of the balance sheet, as for instance 'reserve for future loss on devaluation of inventory'." If you recall the question which I quoted to you, you will realize that this last statement regarding reserve for future loss is completely extraneous to the question and not only detracts from the answer given but represents time taken which might have been put to better advantage.

Again referring to Question No. 1, the candidate stated: "Balance sheets are prepared from the point of view that it presents a realizable value to its readers for the entire balance sheet." This, as you recognize, is a very general statement, does not relate specifically to the question and indicates that it was written hurriedly and without proper thought. The examiner can only conclude that the candidate did not have a very clear concept of a balance sheet.

Again in answer to Question No. 1, the candidate stated that "when we use cost or market, whichever is lower, we automatically provide for broken, obsolete or other goods which are not perfect. The imperfect goods would normally sell for less than regular merchandise." The candidate goes on to say that "there are many methods of pricing inventories and the cost or market method is perhaps the best all-around method and is good except in special circumstances." Nothing in the answer given deals with the question of whether "cost or market, whichever is lower" conflicts with the objective of matching appropriate cost against revenue. Either this candidate did not read the question carefully or he did not have a clear understanding of the basic principles in pricing inventories. I should judge, from the answer given, that the candidate had obtained only a superficial knowledge of the subject. Let me emphasize—answer the questions directly, do not wander with your words.

Question No. 2 reads as follows:

"Receivables may be classified and identified on the balance-sheet under a number of different titles or captions. Give eight captions for receivables, all of which might appear on balance-sheets. Give reasons for using a number of subclassifica-

tions for receivables on a balance-sheet instead of using a single caption for all receivables."

One or two of the candidates, in answering this question, stated that one of the reasons for using a number of subclassifications was that some of the items may be collectible and others may be of a doubtful character. Subclassifications do not characterize receivables as collectible or non-collectible. Was this candidate grasping for an answer or did he have something in mind which he did not explain? Also, this seems to me to be an unfortunate line of reasoning, as it assumes that the question contemplated that receivables might include items not collectible without a proper provision for bad debts. There is nothing in the question which would allow the candidate to make such an assumption. The questions are not tricky nor do they contain hidden meanings.

Another candidate listed eight different titles or captions and then proceeded to give a definition and explanation of each item. The question does not require, nor does it imply a requirement that there should be an explanation or definition of the titles. Thus, time was devoted to the question which not only did not improve the answer but took valuable time from answering other questions. It was noted by those examining the auditing papers that many candidates gave detailed explanations where simple illustrations were called for by the questions. The questions are difficult; do not make them more so.

Again a candidate, in answering this question, stated, "If, for instance, the notes receivable were in one account, we would lose the detail as to when notes are collected." The list given by the candidate did not indicate titles or captions to illustrate this statement. A statement such as this puts a strain on the examiner to understand how the listings would give any information as to when the notes were collectible. Ordinarily, the date of collection is not shown opposite receivables. Help the examiner—be explicit in your answers.

This question, and the answers, illustrate a general observation which I would now like to point out to you. The candidates were asked to give eight captions for receivables. Many of them listed accounts receivable, accounts receivable—officers, accounts receivable—employees, accounts receivable—subsidiaries, and various other subclassifications of accounts receivable or of notes receivable. Some of them included accounts receivable—secured and accounts receivable—unsecured. Technically these may be correct answers, but there is a certain psychological factor which enters into the grading of papers. If a candidate were to list accounts receivable—trade, installment notes receivable, acceptances receivable, dividends receivable and various other major classifications of receivables, the examiner would be more impressed by the candidate's breadth of knowledge and experience and this might have quite a bearing on the grades given. Use your ingenuity. It is a requisite of a good auditor.

I want to refer again to the auditing examination. Some of the questions contemplated a knowledge of internal controls and I am told that many of the papers showed an amazing lack of understanding of this subject. Fundamental to auditing is internal control; audit programs are predicated on the accounting controls, and a knowledge of the essentials of proper control procedures is a prerequisite of a good auditor. The time and effort spent in studying this subject will pay you well, not only in preparing for the examination but also in fulfilling your responsibilities as an auditor.

Question No. 3 was as follows:

"It has been proposed that the 'reserves' section on the liability side of the balance sheet be eliminated and that all such reserves be classified either as liabilities or as part of the stockholders' equity. Give the arguments for and against this proposal."

One candidate stated, "Liabilities in the balance sheet should be actual,

whereas assets are a matter of opinion." The reference to assets is gratuitous and might be construed to be facetious or cynical; neither has a place in answers to examination questions. The use of the expression "matter of opinion" might have been unfortunate, as the candidate may have meant to state that assets are, to a certain extent, based on estimates or judgment. In any case, the statement was not pertinent to this question, and the reaction of the examiner may have meant the difference between a good or a bad grade.

Another candidate gave as an argument for eliminating the reserve section that "the use of these reserves is to hide profit." Also, he gave as an argument for the reserves that "disclosure of hidden profits available for distribution during time when business is bad has a good effect upon the public." Obviously if you use the reserves to hide the profits, then they cannot disclose the hidden profits. Be sure, when you write answers to questions, that you do not contradict yourself. A bewildered examiner finds it easier to make a zero than a 12. I shall not discuss whether I think the answer is correct or not; my point in this particular instance is with regard to contradictions in answers.

Another candidate stated that "the trend in accounting today is to attach more simplified meanings to reserve accounts so they are more easily understandable", and proceeded to give examples of revised wording in reserve accounts. An examiner, reading this answer, would either have to assume that the candidate did not read the question carefully or that he was trying to evade the answer. In either case, the candidate's grade will suffer. Do not pad your answers.

One candidate was being somewhat philosophical when he gave as one of two arguments against the elimination of the reserve section that "people who are not acquainted with financial statements usually do not bother with them and, if they do, they are probably puzzled by other items besides the reserves." Although I might be inclined to agree that many people are puzzled by items other than reserves, I am afraid that it is not a particularly good argument for their elimination from the balance sheet.

Question No. 4 was as follows:

> "The G Corporation carries insurance considerably in excess of the book value of its fixed assets because of the increased cost of replacement. One of its buildings was destroyed by fire and the company collected an amount approximately three times the carrying value of the asset. It then used the entire proceeds from the insurance to construct a similar building. In your examination of the accounts you find that the company accountant, following instructions from the company president, has charged annual depreciation on the new building at the same amount as previously charged on the old building, although depreciation computed on the cost of the new building would be almost double the previous depreciation. The president's argument is that the company must be consistent. Give a complete discussion of the propriety or impropriety of the procedure followed by the company. Do not consider income tax effects."

One candidate stated: "Costs of one period are being applied against the revenue of prior periods and inventories are grossly overstated." Also, the candidate stated, "Inasmuch as this procedure would not result in the presentation of a proper financial statement, a note to the financial statements should be made, giving therein the amount of the variations." This statement is not preceded by any explanation or reason as to why the procedure would not result in the presentation of a proper financial statement. Although the statement may be true, it is not sufficient to generalize without some explanation. I would also like to point out that the use of such words as "grossly" is not advisable. The questions do not, as a rule, necessitate the candidate's using such gratuitous expressions. Merely to say that the revenue is overstated is sufficient. The questions deal with the theory of accounts and usually

do not refer to specific amounts. Do not make assumptions as to materiality unless the questions require you to do so. One examiner mentioned to me that he noted a tendency on the part of some candidates to use big words which were not only misspelled but obviously were not understood.

Another candidate, in answering this question, stated that the president's argument of consistency is false, since the value of the new building is about three times the book value of the old building. His answer so far is acceptable, but then he goes on to say that the inconsistency arises in that the new building may bring greater income to the corporation and that, because of this, there should be a proportionately higher rate of depreciation. This tends to offset the effect of the preceding statement because it leaves the examiner with the impression that the candidate considers that depreciation is related to income rather than to wear and tear.

Another candidate, in answering this question, correctly stated that the depreciation should be increased, but gave as a reason that the new building might be of poor material construction and might not be deemed to remain in as good condition as the old building when it was built. This latter statement is completely irrelevant, and again let me say—do not evade the question by trying to confuse the examiner and be careful in making assumptions not called for in the question. You are the one who will suffer.

One candidate must have been in a terrible hurry, because he wrote, "The methods of applying depreciation are many, and all involve a different charge to surplus." There is an old saying that haste makes waste, and certainly in an examination haste may result in low grades.

Question No. 5 read as follows:

"A manufacturing concern follows the practice of charging the cost of direct materials and direct labor to work in process but charges off all indirect costs (factory overhead) directly to profit and loss. State the effects of this procedure on the concern's financial statements and comment on the acceptability of the procedure for for use in preparing statements."

One of the candidates, seemingly in a desire to show evidence of his broad understanding of the subject, made the gratuitous statement that there are other items such as bookkeeping costs, officers' salaries, and others which could properly be allocated to cost of overhead. Nothing in the question requires any listing of overhead items or any discussion of the type of items which should be included in overhead. The answer to the question does not contain any reference to the type of items that would be considered properly includible in overhead, and many examiners would not consider that all officers' salaries and bookkeeping expenses were proper overhead costs. Here again, the time spent in giving unnecessary information may have reacted to the candidate's disadvantage.

Question No. 6 dealt with the footnotes to financial statements and asked for examples of information which might be contained in an auditor's long-form report, but which probably would not appear in the auditor's opinion or in the financial statements or footnotes. One candidate gave as an example depreciation reserves which are inadequate. This type of information is undoubtedly a good example of what might be included in a long-form report, but the question asked for illustrations of items which would be in the long-form report but not in the auditor's opinion or in footnotes. Either the candidate did not have a proper appreciation of the accountant's responsibility in expressing his opinion where depreciation was inadequate, or he read the question too hurriedly without grasping clearly the type of example requested. Let me beg of you to read the questions carefully not once but at least three times, and after you write your answer read the question in relation to the answer.

Question No. 7 dealt with determining the presence or absence of good will. You would be amazed at the various novel methods that were presented by the candidates. Some of them stated that you determine good will by estimating the amount of the good will, and then explained that this was not a good basis because the estimate might result in an over- or under-value.

One candidate stated, "There is no really good or accurate scientific method of valuing good will. Theorists and text books give six recommended methods; they all have weaknesses. Perhaps the best method, though it has not a scientific or accounting basis, would be the arbitrary method—the seller agrees to accept X dollars in good will and the buyer agrees to pay X dollars." It probably took the candidate quite a while to write that paragraph and he may have hoped that someone would find therein a method of determining good will which would be useful to the purchaser of a business. Believe me, an examiner is not fooled by mere words; and to state that you determine good will by an estimate or by an arbitrary method is a waste of time and leaves anything but a good reaction in the examiner's mind. This is true of all indefinite answers.

Some Major Causes of Failure

Enough of specific illustrations. I have consistently asked the examiners what they consider to be the major cause of failures outside of inadequate preparation. Let me read to you from two memoranda prepared by experienced examiners who have been grading the auditing papers:

(1) "Many of the candidates who received medium grades could have passed the examination had they used a different approach to the problems. In many instances, there was an indication that candidates had sufficient training to qualify them as competent auditors, but through carelessness, haste or nervousness could not fully apply such training to the problems at hand.

"Some candidates read a question once, thought they knew the answer and started writing. Many good answers were written on examination papers by this procedure but they did not apply to the question asked. Each question should be read through several times and thoroughly understood before attempting to answer it.

"Another noticeable fault of a number of these middle-grade candidates is poor timing. Very thorough, complete, at times verbose answers will be given to the first portion of the examination. The candidate then realizes he has very little time left and the balance of the paper is too brief and often wrong. An allocation of time for each question would help such candidates considerably.

"Some candidates waste a good deal of time in trying to display all their knowledge of a subject instead of just answering the specific question asked about that subject. Full explanations are usually necessary, but too often the candidate gets 'sidetracked' into a lengthly discourse of inapplicable data."

(2) "In general, the thing that struck me, as it has in the past, is that the candidates do not seem to read the questions thoroughly. I have always been of the opinion that a candidate should read each question through at least twice and, before he commits pencil to paper, should try to find out what was in the examiner's mind when he asked the question, what knowledge the examiner was trying to test him on, and then try to answer that question in the clearest and most concise fashion."

Some Specific Recommendations for Improvement

As regards specific recommendations to those taking Problems, the following comments will, I am certain, be of value to you:

General practice in preparing work-

ing papers usually embodies the opening facts in trial-balance form, application of assumed conditions thereto and necessary adjustments required, as well as extension into columns for profit and loss and balance sheet. This orderly approach furnishes the examiner with a clear summation of the candidate's reasoning processes. Control of the figures by the candidate is more orderly and deviations quickly discovered. It is far better than disjointed T-accounts, although they have a proper use in certain instances. An accountant on a job would not turn in his working papers in T-account form.

A workmanlike lining up of figures, avoidance of irregular hit-and-miss layout and deliberate forcing of balancing totals, all make for or against the proper impression on the examiner. Totals and carry-forward figures show proper training and understanding of the technique of an accountant.

On occasions, valuable time is wasted writing out journal entries and explanations, when direct postings to working paper should be made with reference to the key number in the problem. *If journal entries are desired, the problem will so indicate, and they then should not be omitted.*

Use separate sheets for each problem or question. This permits expanding and adding thereto upon recheck of the answer by the candidate. It also permits orderly arrangement of all papers upon completion of the examination.

Avoid reversing debit and credit columns and combining debits and credits into one column. It is better to separate them than to use red ink or encircled pencil figures. Use wide-column analysis paper when necessary, and piece it together if cramped for space.

When the examination has been completed, assemble the sheets in proper sequence and number the pages at that time. Fold the work sheets so that they may be readily opened for review. Avoid putting the fastener through the sheets in such a way that the examiner is forced to unfasten and re-arrange them and sometimes even to re-sort them in proper sequence. This permits rapid handling of the papers with the least annoyance and loss of valuable time by the grader. In general, a favorable impression as to an all-around workmanlike approach, neatness and cooperation by the candidate is helpful in securing the favorable attention of the grader.

Remember that a slovenly work sheet makes a poor impression and indicates a state of mind that is undesirable for a practicing accountant. You are a candidate for a profession, so evidence your fitness therefor by the careful layout and appearance of the working papers you submit on your professional examination.

If those of you who are planning to take the examination will go in to it adequately prepared and will keep the things in mind that I have mentioned to you tonight, I'm sure you will find your grade will be quite satisfactory.

How to Prepare For the CPA Examination

By STEPHEN CHAN, C.P.A.

Many helpful hints on how to prepare for and write the CPA examinations are given in this paper. Candidates would do well to study them carefully.

DO NOT be afraid of the CPA examination, it is not so difficult! It is fundamentally no different than the many written examinations given at college. Proper preparation and a proper mental attitude will get you through.

Mr. Henry Mendes, past chairman of the Board of Examiners of the American Institute of Accountants, said:

> "The purpose of the C.P.A. examinations is to provide adequate tests of the candidate's knowledge in certain basic subjects relating to accountancy; candidates do not have to be possessed, necessarily, of the abilities of the leaders of the profession, but only of sufficient ability to meet the average demands."

An analysis in 1947, on a national basis, of the background of candidates who passed all four parts of the examination on the first attempt, indicated that the important factors were youth and education, with public accounting experience of secondary significance. Therefore, it is my opinion that you should take the tests as soon as possible after graduation, while you have the ability to study and before your theoretical knowledge is dulled.

STEPHEN CHAN, C.P.A., is a member of the Society and also holds membership in the National Association of Cost Accountants, the American Institute of Accountants and the American Accounting Association.

Mr. Chan has written a number of articles which have appeared in the *Journal of Accountancy*, the *Canadian Chartered Accountant*, *The New York Certified Public Accountant* and other publications. He is a partner in the firm of Eisner & Lubin, C.P.A's.

This address was delivered before the Accounting Society of The City College School of Business and Civic Administration on April 24, 1952.

CPA Regulations

The State of New York uses the uniform CPA examination promulgated by the American Institute of Accountants and now given in all 48 states. The candidates' papers in most of these states are sent to the Institute Board of Examiners for grading. However, in several states, among them New York, the State Board of CPA Examiners grades the papers.

For information regarding the requirements to sit for the examination, it is suggested that you obtain, from the Bureau of Professional Education, State Education Department, 23 South Pearl Street, Albany, New York, a current copy of "Handbook 14", containing the law, rules and information relating to Certified Public Accountancy.

Graduates of an approved College who are over 21 years of age and who have obtained a B.B.A. or other approved degree in accounting, (see Handbook 14) may immediately sit for the theory and commercial law portions of the examination. To take the auditing and accounting problems examinations, you must first complete three

years of diversified experience in the public practice of accountancy.

Material to be Studied

You can obtain valuable hints on studying and preparing for the examinations from a booklet, published in 1949 by La Salle Extension University of Chicago, and entitled "CPA Examinations and How to Prepare for Them." You may also be interested in reading a dissertation by the late George Bennett, former chairman of the New York State Board of CPA Examiners, giving specific reasons for past failures and setting forth suggestions for avoiding them. This article was published in the May, 1950, issue of *The New York Certified Public Accountant*.

In preparing for the examination, set a time schedule and study in accordance with your plan. Do not attempt to read all the books on accounting which are available in the libraries. Your efforts should be directed towards knowing well what is in several representative texts.

To remain up-to-date on auditing and theory you should also read the bulletins issued by the American Institute of Accountants' Committees on Accounting and Auditing Procedure. The Research Bulletins cover present-day thinking on such varied matters as Verification of Receivables and Inventories, Form of Accountant's Opinion, Depreciation on Appreciation, Definition of Current Assets and Liabilities, Inventory Reserves, Treatment of Stock Options, etc. These topics often form the basis for questions in the examination.

It is also suggested that you read the *Journal of Accountancy, The New York Certified Public Accountant,* and *The Accounting Review* to keep abreast of current developments and discussions.

You should also possess a general knowledge of the current Federal income tax regulations.

To pass the law examination you should review from a commercial law outline book, such as is used to prepare for the high school Regents' examination. In addition, you should study a representative text for the review of details not covered in the outline.

As a guide in proper preparation, it is useful to know what types of questions are being asked. In this connection, you should review the actual CPA questions and suggested answers thereto, published in the *Journal of Accountancy*.

The problems examination can best be prepared for by carefully going over the solutions to the problems which you studied at college, and by reviewing the answers to the actual CPA examination problems in the *Journal of Accountancy* or in one of several CPA review books. You should also work out problems and check yourself with a published solution. You must strive to develop both speed and accuracy.

Method of Study

Memory plays an important role; if in your review you have covered a standard work on Theory, one on Auditing, and one on Commercial Law, and read the American Institute Bulletins and the periodical literature, you should have no difficulty with the examinations. However, you must know your subject well, and not rely on guesses or hazy recollections. It is, therefore, suggested that, when studying for the examination, you read the textbooks and other material carefully and slowly, as though it is the first time you have seen them. After the first complete reading, study another subject. Then, upon completing the material you have outlined for all subjects, reread each subject. This program will result in a thorough reading and study, followed by a faster review at a date closer to the time of the examination.

It is important to adhere to a planned schedule of study hours to en-

able you to cover the required material properly. The average June graduate who desires to sit for the Theory and Commercial Law portions of the examination in November should be able so to budget his time between July and November as to cover thoroughly the comparatively small amount of material required for these examinations.

The recent graduate does not, in my opinion, require a formal review course. However, if you cannot adhere to a schedule and must be helped to study, if you fail on several attempts, or if you sit for the examination years after college graduation, one of the established CPA review courses may be beneficial.

Being physically fit plays an important part in passing any examination. Get sufficient fresh air and exercise during the weeks you are studying. See that you obtain sufficient sleep for several nights before the tests and that you approach the examinations with a clear, alert mind.

Examination Technique

Enter the examination room with two filled pens, two mechanical pencils, a six-inch ruler, and a clean eraser.

When you receive the questions, review them *all* before writing any answers. Read the instructions carefully; for instance, some candidates disqualify themselves by signing their names to the papers instead of using only their assigned number. Other candidates skip required questions and answer excess optional questions; no credit is given for answering more than the required number of questions.

After reviewing all questions, decide which seem to be the easiest and, after reading them carefully, answer those first. Putting down what you know will give you confidence; once you are well started the remaining questions will not appear so formidable.

Start each answer on a fresh sheet of paper. Do not write too much. Do not copy the question. Write only your answer and write only enough specifically to answer the question. Do not try to display all your knowledge and do not give gratuitous information. A one-half to a full page answer should suffice for nearly all questions.

For instance, if a problem requests a profit and loss statement, do not also furnish a balance sheet. If a question asks for the accounting treatment or effect of a specific transaction, do not submit the treatment for Federal income tax purposes. If a question requires three methods or illustrations, do not give four or two.

The questions are usually specific and are not presented to trick or confuse the candidate. However, they must be read carefully.

Write clearly; do not scribble or abbreviate. The examiner must be able to read and understand your answer, in order to allow you credit for it.

Be careful of your terminology. For instance, do not write "surplus" when you mean "donated surplus" or "capital surplus"; do not write "liabilities" when you mean "notes payable."

If you begin to flounder on a question, do not waste time; put it aside and proceed to the next choice. Aim to complete those answers you know well, before spending excess time on the questions which are not clear to you. Keep the time allowance and the point allowance for each question in mind and pace yourself accordingly. Try to leave some time for a final review of your answers. However, do not rush through the examination; no prize is given to the one who finishes first.

If a question appears controversial, it may sometimes be well, after stating your reasoning or solution, to mention that there is another method in use stating, however, that in your opinion it is less preferable.

Illustrations of Proper Answers

To illustrate the proper method of answering Theory questions, let us review two questions of the November

1951 examination and the suggested answers.

Question number 3 stated:

"It has been proposed that the 'reserves' section on the liability side of the balance-sheet be eliminated and that all such reserves be classified either as liabilities or as part of the stockholders' equity. Give the arguments for and against this proposal."

Although somewhat controversial, this question may be correctly answered in three short paragraphs, as follows:

In general, elimination of the "reserves" section is a desirable change. Since a balance-sheet is a statement of assets, liabilities and capital, there is limited use for an intermediate category. The reader of a balance-sheet should not be required to evaluate the need for "reserves" but should be entitled to presume that such amounts represent reasonable estimates. The use of the word "reserve" is not always good terminology and, therefore, elimination of the so-called "reserve" section involves determination of the real nature of the provision, and its proper terminology.

Some liabilities are not of the "current" category and cannot be precisely determined. Therefore, a section of the balance-sheet for non-current or deferred liabilities is appropriate. It may include provisions for such items as self-insurance, premium coupon redemptions after one year, and pensions. Such amounts should be appropriately captioned (in certain instances the use of the word "reserve" may be involved) and are properly excludable from capital or surplus.

A reserve for contingencies in the absence of some obligation or event subject to estimated calculation, is as much a part of surplus as the retained earnings which have not been especially labeled. In a few circumstances, however, there may be a place for the "suspense" type of liability reserve. The close of an accounting period is an arbitrary division of the history of a company and some transactions may still be uncompleted and their final outcome uncertain. The reserves for contract renegotiation and post-war rehabilitation, which were so common immediately after the close of World War II, were perhaps of this type.

Question Number 5 stated:

"A manufacturing concern follows the practice of charging the cost of direct materials and direct labor to work-in-process but charges off all indirect costs (factory overhead) directly to profit and loss. State the effects of this procedure on the concern's financial statements and comment on the acceptability of the precedure for use in preparing statements."

This question could also be the subject of a prolonged dissertation, but an answer on one sheet, approximately as follows, would probably receive full credit:

Cost to manufacture usually includes direct labor, direct materials and applicable indirect factory costs. Consequently, by omitting indirect factory costs from work in process, the concern is understating inventory accounts in comparison with concerns which follow the usual practice. At any particular point of time its balance-sheet is incorrectly stated in the following particulars:

(1) Work-in-process and finished goods are understated.

(2) Current assets are understated, and so is its net working capital and the current ratio.

(3) Total assets are also understated.

(4) Liabilities are not affected but net worth is understated, specifically in the earned surplus account.

Of equal importance is the effect on the results of operations. Unless the amount of work in process and finished goods happens to be the same at each balance-sheet date, costs and revenues will not be matched in the usual manner, resulting in a corresponding distortion of reported net income.

It is not a generally accepted accounting principle to omit factory overhead from inventories. While the cost of idle facilities, excessive spoilage and certain other unusual items may be treated as period costs, the usual indirect costs are considered to be assignable to the production of the period. Therefore, where feasible, these indirect costs should be computed with the direct costs and flow through inventories.

Reorganization of the Bureau of Internal Revenue

By JACK SCHLOSSER, C.P.A.

This article outlines the changes recently made in the reorganization of the New York City District and the Washington Headquarters of the Bureau of Internal Revenue. Both administrative procedures and personnel organization are considered from the viewpoint of clarifying the effect of the changes on the every-day conduct of a tax practice.

EFFECTIVE July 1, 1952, the proposed Reorganization Plan No. 1 of 1952 was put into effect in the New York City Area by the Bureau of Internal Revenue. It had previously been implemented in Illinois, and it is expected that the entire reconversion from the old to the new system of operation will be completed throughout the United States by the close of 1952.

This article cannot attempt to cover every aspect of this huge administrative maneuver, its origins and evolution, its basic philosophies, its ultimate goals, etc. It will, instead, confine itself to a bare outline of the actual changes made in personnel set-up and procedures with an eye toward clarifying the effect of these changes on the everyday conduct of a tax practice. To simplify and concretize the ensuing discussion, a chart has been appended which diagrams the entire series of changes. (See page 550.)

JACK SCHLOSSER, C.P.A., is a member of our Society and Chairman of its Committee on State Taxation.

He was graduated from The City College (New York) School of Business and Civic Administration in June, 1939, with the degree of B.B.A.

Mr. Schlosser is a partner in the firm of Eisner and Lubin, CPAs.

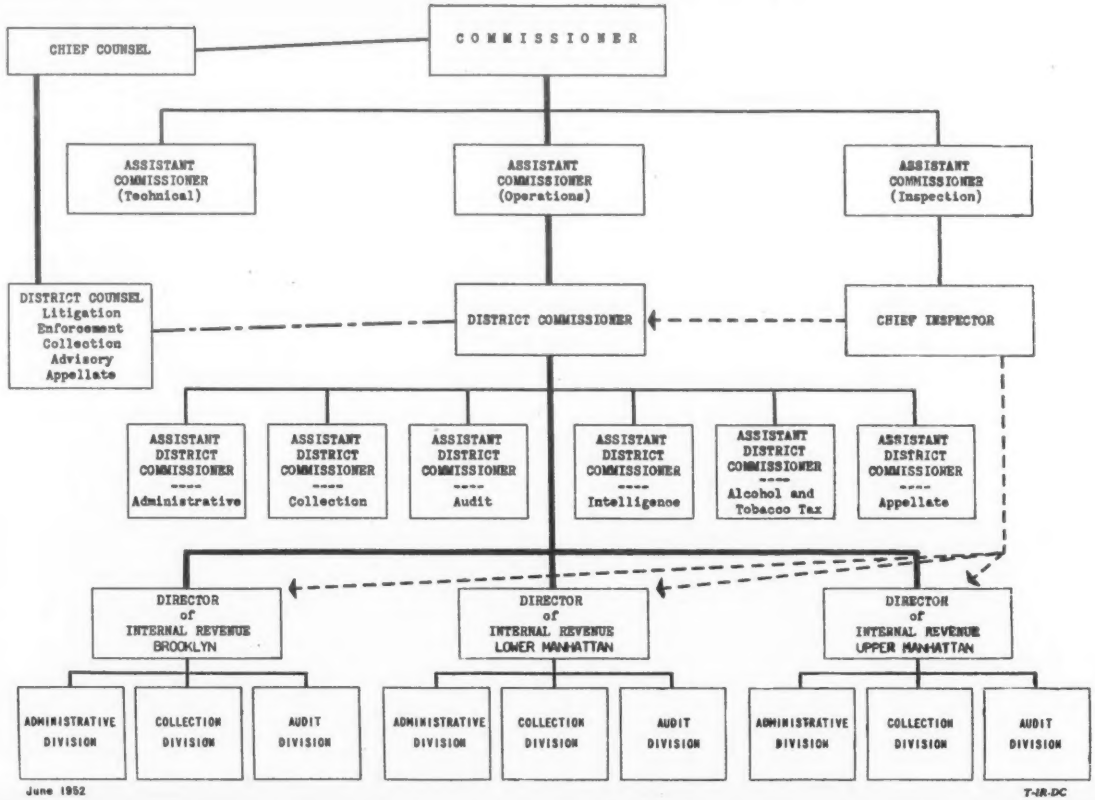
The principal aim of the Reorganization Plan is to integrate all of the functions of the Bureau on a regional basis and to decentralize national authority by making each region as self-sufficient and independent as possible. In a capsule form the underlying principle might be summarized as "Decentralization at the national level; centralization at the local level."

New York City District

As we have indicated, the New York City phase of the over-all Plan was quietly implemented on July 1, 1952. The entire geographical area previously embraced by the First, Second and Third Collection Districts has been consolidated into one New York City District headed by a District Commissioner with offices at 90 Church Street*.

The District Commissioner will exercise general administrative supervision over all Federal tax matters within his District and will have a clear and direct line of authority to the Commissioner of Internal Revenue in Washington. In fact, the District Commissioner will be the only line of communication to the national office from the New York City area, which contrasts sharply with the former status where there were three Collectors, three Agents in Charge, one Alcohol and Tobacco Tax Supervisor, one Appellate Staff and one Regional Finance office reporting directly and

*C. R. Krigbaum, formerly Internal Revenue Agent in Charge, Second District.


CHIEF COUNSEL
COMMISSIONER
ASSISTANT COMMISSIONER (Technical)
ASSISTANT COMMISSIONER (Operations)
ASSISTANT COMMISSIONER (Inspection)
DISTRICT COUNSEL Litigation Enforcement Collection Advisory Appellate
DISTRICT COMMISSIONER
CHIEF INSPECTOR
ASSISTANT DISTRICT COMMISSIONER ---- Administrative
ASSISTANT DISTRICT COMMISSIONER ---- Collection
ASSISTANT DISTRICT COMMISSIONER ---- Audit
ASSISTANT DISTRICT COMMISSIONER ---- Intelligence
ASSISTANT DISTRICT COMMISSIONER ---- Alcohol and Tobacco Tax
ASSISTANT DISTRICT COMMISSIONER ---- Appellate
DIRECTOR of INTERNAL REVENUE BROOKLYN
DIRECTOR of INTERNAL REVENUE LOWER MANHATTAN
DIRECTOR of INTERNAL REVENUE UPPER MANHATTAN
ADMINISTRATIVE DIVISION
COLLECTION DIVISION
AUDIT DIVISION
ADMINISTRATIVE DIVISION
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AUDIT DIVISION
ADMINISTRATIVE DIVISION
COLLECTION DIVISION
AUDIT DIVISION
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independently to Washington from this District. The District Commissioner will be assisted by six Assistant District Commissioners with the following titles and duties:

(1) *Assistant District Commissioner, Administrative*

(2) *Assistant District Commissioner, Collections*

(3) *Assistant District Commissioner, Audit*

These officers will be located at 90 Church Street where they will each operate a small staff for purposes of technical control and with an eye toward supervising and coordinating the work of each of their counterparts at the Director's level as will be detailed at a later point. Theirs will be purely an advisory, management and policy-making function.

(4) *Assistant District Commissioner, Intelligence*

This officer will assume the functions of the present Special Agent in Charge and will, like his predecessor, be located at 253 Broadway. All of the fraud work previously conducted by the Special Agent in Charge will be continued at the Assistant District Commissioner level for the entire District and in substantially the same fashion. Thus, there will continue to be Special Agents operating directly from the "253" office; joint investigations by special and regular agents may still be held; recommendations for prosecution will still emanate from this office. It will be the responsibility of the District Commissioner to coordinate the work of the Directors' offices and the Intelligence Division insofar as fraud investigative activities are concerned.

(5) *Assistant District Commissioner, Alcohol and Tax*

All of the functions of the District Supervisor, Alcohol and Tobacco Tax in the New York City District, including the issuance of alcohol permits, will be assumed by this agency with offices located temporarily at 143 Liberty Street.

(6) *Assistant District Commissioner, Appellate*

This officer will assume the authority of the former Head of the Appellate Staff to represent the Commissioner exclusively in the settlement of all types of tax controversies. Agreements reached with the Appellate Division will generally be final and will not be reopened in the absence of fraud, malfeasance, concealment or misrepresentation of a material fact, or a major error in mathematical calculation. Post-review in Washington will be only for the purpose of assuring uniformity in tax administration policy. As in the past, settlements may be attempted with this Division after the filing of a Tax Court petition but before trial. All of the appellate procedures available for income, estate and gift taxes are now applicable to excise tax controversies as well, with the exception that there is still no right of appeal to the Tax Court for cases involving excise taxes. The office of this Assistant District Commissioner will continue to be located at the Empire State Building.

It should be noted that only in New York City, because of its restricted geographical area, will the Intelligence operations, the Alcohol and Tobacco Tax activities, and the Appellate functions be conducted at the Assistant District Commissioner's level. In other Districts there will be three such divisions under the supervision of each Director of Internal Revenue. The function of the applicable Assistant District Commission will, in such districts, be purely one of policy-making and coordination.

Director of Internal Revenue

We come now to the office which is of greatest interest to taxpayers and their representatives, the Director of Internal Revenue. The New York City District has been divided into three Directors' offices corresponding

geographically with the old Collection Districts*. Each Director will be charged with the authority and responsibility of the former Collectors relating to the assessment and collection of taxes. In addition, they will assume all of the audit functions formerly conducted by the Internal Revenue Agents in Charge. Finally, they will be responsible for all matters relating to personnel, training and administrative services. The work of each Director, as outlined, will be conducted through three Divisions: Collection, Audit, and Administrative; each Division will be supervised by a Head of Division responsible to the Director.

The office of each Director will be located, until further notice, at the premises formerly occupied by the respective Collector of Internal Revenue. All Federal tax returns will, therefore, continue to be filed by each taxpayer in the same district and at the same address. Remittances should not be made out to the "Collector of Internal Revenue" but should be made payable to the "Director of Internal Revenue".

As indicated, returns will be filed with and payments made to each Director of Internal Revenue. Claims for refund will be filed with the Director and suits for refund will be filed against him on the same basis as they have in the past been filed against the Collector. Returns and claims will be examined by Agents connected with the Audit Division of the Director's office. At the request of the taxpayer, informal conferences may be held at the Director's level, usually with a group chief to settle the handling of disputed items. If there is still disagreement, an appeal may be taken, but not at the Director's level. This appeal will be handled by the office of the Assistant District Commissioner, Appellate, although the protest will be filed with the Director.

In connection with the Reorganization Plan, as applied to the Director's office, the following should be noted:

(1) The functions of the Alien Income Tax Unit, located at 292 Madison Avenue, will continue substantially as in the past, but will fall under the supervision of the Director of Internal Revenue for Upper Manhattan.

(2) All of the audit procedures previously conducted by the Collector's office will be separated from the Collection function and will be consolidated in the Audit Division.

(3) The delinquent returns and collection work formerly carried on by Field Deputy Collectors will also be transferred to the Audit Division, thus placing all out-of-office taxpayer contact under the unified direction of the one section.

(4) The unification of all audit activities has as one of its ultimate objectives the rendering of so-called "one-shot" audits wherever feasible. These audits call for the examination of all of the returns of a single taxpayer at one time, whether such returns relate to income, excise, social security or other types of Federal taxes. Such examinations may be conducted by a team of agents if the size and complexity of the returns require it.

(5) Eventually, it is expected that the work of each Audit Division will be broken down between an Office Audit Branch and a Field Audit Branch.

(6) To facilitate the new informal conference procedure at the Director's level, the number of group chiefs was recently increased and the number of agents in each squad was reduced to about 20 agents. This step was taken to permit closer supervision of the agents by the group chief and also to afford him adequate time to devote to the holding of informal conferences.

Agreements reached at informal conferences will generally be considered as

* Director of Internal Revenue—Upper Manhattan—Harold Ahearn
Director of Internal Revenue—Lower Manhattan—Dennis McMahon
Director of Internal Revenue—Brooklyn—Henry Hoffman

final, although subject to review by the review section of the Audit Division and also to a post-review in Washington. The Bureau has indicated that such agreements will not be upset unless there is a clearly defined misapplication of law, misrepresentation or omission of a material fact, or an important mathematical error.

(7) Offers in Compromise of tax liability on the ground of inability to pay will be filed with the applicable Director of Internal Revenue. They will be investigated in the field under his direction, presumably by the Audit Division. The final decision on behalf of the Commissioner as to acceptance, revision or rejection of an offer will be made by the office of the Assistant District Commissioner, Appellate.

Washington Headquarters

As previously outlined, the Reorganization Plan at the District level attempts to improve operating efficiency by a consolidation of functions and by the integration of lines of authority and responsibility. The same principles have guided the reorganization of the Washington office.

The Commissioner of Internal Revenue continues as the over-all administrative head of the Bureau of Internal Revenue responsible directly to the Secretary of the Treasury. He will be assisted by three Assistant Commissioners, all of whom will be civil service appointees. The responsibilities and duties of each of these Assistant Commissioners follow:

(1) *Assistant Commissioner (Technical)**

Specifically, this office will concern itself with such matters as technical rulings, foreign tax treaties and other special technical services. This Assistant Commissioner will have no line control over any of the Field Offices. Field Offices will direct requests for rulings to the Assistant Commissioner (Operations), who will, in appropriate cases, request the advice of the Office of the Assistant Commissioner (Technical). On the other hand, this office will be the source of technical rulings to taxpayers, and the procedure in such matters will continue in much the same manner as in the past.

(2) *Assistant Commissioner (Operations)***

This office, under the general direction of the Commissioner, will have authority to direct all field operations except those of the Chief Counsel and Inspection Service. This one office will supplement the following independent offices now performing these duties: Income Tax Division, Account and Collections Division, Intelligence Division, Alcohol and Tobacco Tax Division, Appellate Staff, etc. The direction of field activities will undoubtedly require segregation into various divisions, each to be supervised by a Head of Division. However, instead of being separate and independent agencies, each of these Divisional Chiefs will be responsible to and supervised by the aforementioned Assistant Commissioner (Operations).

(3) *Assistant Commissioner (Inspection)***

This office will be charged with responsibility for investigating and maintaining the desired high level of efficiency and integrity on the part of all Bureau employees. Field offices will be maintained under Chief Inspectors who will function independently of other Bureau officials and who will report directly to the Assistant Commissioner (Inspection) in Washington.

Legal Activities

Legal matters growing out of the work of the Bureau will, under the proposed Reorganization Plan, be conducted organizationally as follows:

(1) In Washington there will be a

* Norman A. Sugarman.
** Justin F. Winkle.
*** Edgar E. Hoppe.

Chief Counsel who, in effect, will be the legal advisor to the Commissioner of Internal Revenue and to the various other operating officials at the national level.

(2) At the District level, there will be a District Counsel responsible to the Chief Counsel, providing legal services for the District Commissioner, the Assistant District Commissioners and the Directors of Internal Revenue, including representation of the Commissioner in cases before the Tax Court.

(3) Within each District, and subject to the general direction of the District Counsel, there will be an Appellate Counsel who will furnish legal advice to the Assistant District Commissioner, Appellate, and who will represent the Commissioner in Tax Court trials; an Enforcement Counsel who will handle legal matters in connection with criminal cases arising under the Internal Revenue laws; and Attorney in Charge (Alcohol and Tobacco Tax) who will furnish legal advice to the administrative officers of the District responsible for enforcing laws relating to alcohol, tobacco, firearms and tort claims. In addition, there will be a Civil Advisory Counsel available to render advice to each Director on matters connected with the collection of taxes and such other general legal problems as may arise from time to time.

Conclusion

The foregoing represents, in summary form, a description of the reorganization as applied to the New York City District and to the Washington Headquarters of the Bureau of Internal Revenue. From time to time, changes may have to be made to adjust to more efficient means of administering the work of the Bureau. Any changes will be made clear to taxpayers and their representatives as they are implemented. As previously indicated, the aim of this entire reorganization has been to streamline and pin-point lines of authority, to render uniform the collection and enforcement of *all* of the Federal taxes, to provide for closer supervision on the integrity and efficiency of individual Bureau employees, and to make the Bureau a career service in which all positions under the Commissioner of Internal Revenue will be filled solely in accordance with the civil service merit system. Only time will tell whether all of these ultimate aims will be accomplished.

The Basic Philosophy Underlying Financial Accounting

By WILLIAM L. CAMPFIELD, C.P.A.

Accounting methodology requires guidance and motivation by some basic philosophy. To serve effectively as an instrument of management control, accounting must partake of the attributes of scientific method and adhere to the facts as they occur.

TODAY more than ever before there is vital concern with the meaning and measurement of net income by all persons who have an interest in business enterprise. Needless to say, the manner in which enterprise management interprets accounting principles in the major areas of financial accounting will profoundly affect the net income figures derived in consequence of the operations of a given fiscal period.

Public accountants who are charged with the responsibility of appraising management interpretations in the important areas of financial accounting must perforce render demonstrably sound opinions if they expect to receive the universality of confidence for which they are constantly striving.

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Dr. Campfield is engaged as Regional Cost Accountant in the San Francisco office of the Office of Price Stabilization and also serves as Lecturer in Accounting at the University of San Francisco.

Accounting Purposes Are Rooted in a Fundamental Credo

Accounting methodology, in much the same fashion as the purpose of any individual, nation, institution, or activity, must be guided and motivated by some basic philosphy. Motivation is the one thing irrespective of time or place which stands out clearly and distinctly as the force ascribing meaning and purpose to an individual's or a group's actions. This basic philosophy underlying all accounting action is very aptly outlined in the following statement:

> Financial accounting is now generally recognized as being historical in character and as having for its most important function the extraction and presentation of the essence of the financial experiences of business, so that decisions affecting the present and the future may be taken in light of the past.[1]

Hence, the recordation of historical financial facts means in the first instance a quantitative measurement of transactions expressed in a common monetary unit, e.g., the dollar.

The problem of monetary measurement and recording of transactions is but one facet of the basic accounting philosophy. Another is the nature of the principles to be observed for subsequent re-measurements and interpretations. It is one thing to collect actual historical facts and quite another to interpret those facts as a basis for the formulation of enterprise and other decisions. The purely recording function

[1] George O. May, *Financial Accounting,* The Macmillan Company, New York, 1943, Foreword p. vii.

of the accounting method, indispensable as it is, primarily concerns only accounting technicians. But the analytical and interpretative functions are of concern to managers, public accountants who must review management's interpretations, and a host of other persons whose decisions will be predicated upon the manner in which interpretative presentation of figure-facts is made. One type of analysis is made to afford management aid in the discharge of its obligation for proper conduct of an enterprise. Another type culminates in the presentation of statements relating to financial position and results of operations of a business for the guidance of directors, stockholders, credit grantors, and others.

During the entire course of assembly of historical financial facts a person must be certain that the basis on which they are assembled is constant. This is a fundamental principle underlying the scientific method. It is best typified by a cardinal admonition of all mathematicians: the unit in which a problem is expressed must remain the same throughout the calculations if a correct solution is to be obtained.[2] If the accounting method, which partakes of all of the attributes of scientific methodology, is to serve effectively as a guide for management in charting the direction of an enterprise then there must be an adherence to the facts as they occurred and in the lawful money of the time.

To be sure, many beneficial results will accrue from reflecting the facts as they happened. Chief among these is the freedom from confusion as to the latest deviation from principle that has been introduced into a given interpretation. The facts are always present in a dollar and cents language to which everyone has been oriented. Should any person wish to perform any statistical calculation, interpretation, or comparison on any other than a historical basis he can be assured that he proceeds from and will always be able to return to a measurement basis that is constant.

The term measurement as embraced in the basic accounting philosophy carries no connotation of present worth or value but only the dollar amount of an item considered for entry in the accounting records and presentation in the primary reports thereon. From the inception of a business enterprise unit and thereafter throughout its operating life, funds or properties flow into the business from owners, creditors, customers or other sources all stated in the dollar amounts expressly or impliedly set forth in the transaction contract. Since an essential need of management is to have adequate information on the status of investment outlays at all times, the accounting records of transactions must, if they are to possess factual dependability, be expressed in the same terms and measure.

Accounting measurement is not in the vast majority of cases an exact science, i.e., a process of finite determination. After the original recordation of historical cost outlays, re-measurement must generally be somewhat of an estimate though based upon a wide range of experience. As Kester points out, the determination of the measured amounts of the several elements of cost, the proper differentiation between capital and revenue charges, and the calculation of the amount of depreciation necessary to the re-measurement of fixed assets are all estimates.[3] From their very nature and the influence of localized conditions in a given case these items cannot be subjected to any universally applicable laws of experience. However, if measurements are carefully performed in the light of all available facts pertinent thereto, the expression of a management's opinion in the financial statements of an enterprise should approximate as nearly as humanly possible a statement of fact.

[2] W. I. McNeil, "Do You Have an Accounting Philosophy?", *The Controller*, April, 1949, p. 172.

[3] Roy B. Kester, "Measurement in Accounting", *The New York Certified Public Accountant*, October, 1944, p. 612.

The Influence of Accounting Conventions, Rules, and Principles

The framework of accounting measurement and interpretation is built around a foundation of accounting convention, rules, and principles. These embrace ideas representing a conjunction of accounting theory with accounting practice. The accounting superstructure has been predetermined by these conventions, rules, and principles and in this respect all interpretations of accounting data, to be valid, must be viewed in this frame of reference.

Basic to an understanding of accounting determination of net income is a reasonable concept of investment outlays, i.e., expenditures and their purpose. Gilman reports that it is only from the relationship between expenditures and realized revenues that some of the more conventionalized aspects of net income are derived.[4] Expenditures, it is agreed by all persons familiar with the rationale of business enterprise, are generally made for the purpose of inducing present or future income. Hence, a determination of that portion of expenditure or cost outlay which is to be charged to current revenue and that portion which is to be deferred to operations of future periods lies at the very heart of the basic accounting philosophy and requires an insight and discriminatory ability which only the person of well-trained powers of reasoning and accounting knowledge can produce.

In general, the purpose of accounting is oriented to the efforts of business enterprise to produce net income. In consequence, it has been stated that the accounting method of treating cost outlays embraces three stages: (1) initial recognition, measurement, and classification; (2) a tracing of subsequent internal movements and re-groupings; and (3) final matching with revenue in the present or some future fiscal period.[5] In tracing these stages, accounting methodology calls for a distribution of the deferred outlay costs ratably and equitably against the revenues of the several accounting periods involved, insofar as practicable, in accordance with the accounting periods benefitted and in proportion to these benefits.

Even among the critics of accounting methodology there are those who recognize that the concept of "business income" should in the first instance be that which the informed opinion of accountants say it is, i.e., the net income of a business enterprise should be defined fundamentally by a set of accepted accounting conventions.[6] This proposition, however, has been subject to the qualification that the accounting conventions so accepted should convey the same basic meaning to any two accountants working with the same data and that users of the accounting net income figures should be free to make special purpose modifications of "business income" so defined, provided they specify the modification. Such so-called qualifications are not inconsistent with the basic philosophy underlying accounting methodology for the latter purports to present financial facts on a given enterprise. Within a reasonable degree all well-trained accountants will agree on the facts in a specific case. That users of financial statements should be free to adapt them to their own special purposes is implicit in the concerted efforts of the organized accounting profession to render opinions on enterprise statements as objective and factual as possible in the circumstances.

In basing its measurement activity upon a continuous business or going-concern convention, accounting method-

[4] Stephen Gilman, *Accounting Concepts of Profit*, The Ronald Press Company, New York, 1945, p. 289.

[5] W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*, American Accounting Association, Chicago, 1940, p. 25.

[6] M. A. Copeland, "Accounting Conventions Should Determine Business Income", *The Journal of Accountancy*, February, 1949, p. 107.

ology reflects a conception of usefulness of cost outlays embodied in integrated property dedicated to a specific enterprise objective and not in independent units of alternative use-value. In other words, the accounting method does not attempt to portray the measurement of the amount which properties or other cost outlays would bring if and when offered for sale in the market. Rather, as indicated earlier, accounting methodology is concerned with recordation of an investment outlay in the first instance, and thereafter with apportioning this outlay over its service rendering life. Apportionment is made to revenue on the basis of an outlay's contribution to the production of revenue or upon its expiration over a period of time without having made a contribution. Any departure from this fundamental basis of accounting measurement can only be justified by a demonstration that ascertainment of the amount of an investment outlay is not reasonably attainable or that outlay cost has convincingly lost a portion of its service potential and therefore should be adjusted.

Summary

Net income determination under the historical cost method lies at the heart of the whole of accounting methodology. As such it is, reports one writer, in accord with the concept embodied in the institutional framework of contracts, banking, tax laws, and the bulk of society's faith in the lawful money of the time.[7] Hence, the basic philosophy of financial accounting which conceives its measurement of enterprise efforts and accomplishments in terms of a historical cost principle is in agreement with the concept of net income or profit by society as a whole, the special purpose concepts of pure profit in economics to the contrary notwithstanding.

It is almost axiomatic that the test of the private enterprise system and of the phase of it represented by the accounting method ultimately resides in the results produced by that system and as reported in part through use of accounting techniques. These results are judged from the standpoint of society as a whole—not from that of some one or a limited group of interested persons.

Should accountants, either public or internal, accede to any of the entreaties to depart from the cost basis and approve one or more of the current value methods of determining net income, they would invite the very type of distrust which they have sought so long to alleviate. For they would have left themselves open to the logical criticism of having presented an amount with the label "net income" that was not the concept of ordinary discourse or the conception of the social institutions which caused net income to be established as a motivating force of the private enterprise system.

[7] A. C. Ellis, "Cost Basis in Accounting Must be Used . . .", *The Journal of Accountancy*, July, 1950, p. 44.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Fiduciary Returns—Non-resident Beneficiaries

A non-resident beneficiary of a resident trust is taxable only on his distributive share of income from a business carried on by the trust or of rents derived from real estate in New York owned by the trust. The non-resident beneficiary is not taxable on his distributive share of any other income of the trust. If all the beneficiaries of a resident trust are non-residents and none of the income of the trust is taxable to them, is the filing of a fiduciary return necessary?

Deputy Commissioner Kassell recently rendered an opinion stating that a fiduciary return is required if any of the income of an estate or trust is distributable to *any* beneficiary and such income amounts to $1,000 or more. As authority for this opinion, Commissioner Kassell calls attention to Section 368.3 of the Tax Law and Article 246b 2 of the Regulations. According to the law and the regulations the requirement for filing the return covers *any* beneficiary and does not distinguish between a resident beneficiary subject to tax or a non-resident beneficiary who may not be subject to tax.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Unincorporated Business Tax—Economic Consultant

The economist has been persistent in resisting the determination of the State Tax Commission that his income from services as consultant and adviser in private industry is not exempt from the unincorporated business tax. The latest case is that of Professor Backman[1] of New York University. Such services, argued the Tax Commission, do not constitute the practice of a profession and the Appellate Division agreed with the Tax Commission. In analyzing the activities of Professor Backman the court said that his services dealt "with the conduct of business itself rather than the application of some separately developed art or science in the needs and uses of business." Probably this distinction explains the reason why other activities of Professor Backman were exempt from the tax, such as income received as editorial writer for the New York Times, economic editor of Trusts and Estates magazine, and from miscellaneous writings. Professor Backman has four degrees, but the court noted that none of them is a degree in economics although it was conceded that he earned the degrees "with specializing in the field of economics."

[1] *Application of Backman*, N. Y. Sup. Ct., App. Div. 3rd Dept., May 7, 1952, 112 N. Y. S. (2d) 365.

Director's Fees of a Non-resident—Withholding Required

Fixed or determinable, annual or periodical income received by a non-resident are subject to the withholding provisions of the income tax law. Deputy Commissioner Kassell ruled recently[2] on the question of whether fees paid to a non-resident director of a corporation come within the withholding provisions of the law (Sec. 350.10 and Sec. 366.1). In the particular situation the director attended regular meetings of the Board every two weeks. The compensation consisted of a flat sum fixed in the by-laws of the corporation for each meeting attended. The total fees for the year exceeded the personal exemption and optional standard deduction.

The ruling held that fees paid to directors represent compensation for personal services rendered within the state and were taxable to non-residents. The fees came within the category of fixed determinable income, since there was a basis for their calculation and they were paid or credited to each director periodically. To the extent that the fees exceeded the personal exemption and optional standard deduction, the deducting and withholding provisions apply.

Deduction for Expense of Preparing Income Tax Returns

Ordinary and necessary expenses incurred in the management of property held for the production of income are deductible in determining taxable net income. Would the cost of preparing an income tax return be considered as such an ordinary and necessary expense? Before the decision in *Bingham's Trust* v. *Commissioner*,[3] there was considerable doubt as to the deductibility of any expenses of this type. After that decision the Tax Commission conformed its regulations to the federal rule (Art. 111a) and permitted the deduction of ordinary and necessary expenses "paid or incurred by an individual in the determination of liability for taxes upon his income."

In a recent ruling[4], Deputy Commissioner Kassell states that such expenses are in the same category as expenses of litigating a taxpayer's liability. He also points out that the federal law has allowed such a deduction since the Commissioner acquiesed in the decision of *David L. Loew* v. *Commissioner*.[5]

Medical Expense Deduction

In the June, 1952, issue of the State Tax Forum I commented on the medical expense deduction. I stated that in my opinion the medical deduction would be prorated on returns for husband and wife, where one spouse dies during the year. Two members have written to me on this item. One member asks me to state the basis for my opinion. This member quoted from a letter he had received from the Income Tax Bureau stating that since a joint return may not be filed where one spouse dies during the year (unlike the federal rule) the maximum medical deduction would be limited to $750. The other member informed me that the Income Tax Bureau had allowed a maximum deduction of $1,500 in a similar situation.

The basis for the opinion expressed was an informal off-the-record opinion of two top officials of the State Tax Commission. At a tax meeting at which state tax officials were present, a member asked me my opinion on the question of the maximum medical deduction where one spouse dies during the year. I discussed the question with the tax officials. Later I researched the point in the law and regulations and concluded that a proration would probably be permitted, similar to the proration

[2] June 22, 1952.
[3] 325 U. S. 365.
[4] June 25, 1952.
[5] 7 TC 363; Acq., 1946—2 C.B. 3.

for the personal exemption. In the absence of an official ruling it is still my opinion that a proration is equitable and would probably be permitted. In the two cases submitted to me the Income Tax Bureau approved the proration in one case, but not in the other. A legal opinion would be desirable.

Real Estate Corporation—Change in Classification

Section 182.1 states the requirements for classification as a real estate corporation. To a limited extent a real estate company may invest in stocks, bonds or loans. This limitation reads as follows: "For purposes of this section, a corporation shall be deemed to be wholly engaged in such activities (real estate) if, during the preceding year, not more than 10 per centum of its average gross assets at full value, consisted of stocks, bonds or other securities or loans to wholly owned subsidiaries taxable under this section."

The question has been asked whether a real estate corporation would lose its classification if it held treasury stock in an amount which exceeds 10 per cent of its average gross assets.

Under Article 9A, treasury stock is held to be an asset which must be included in investment capital (Reg., Art. 331). Under Art. 9, treasury stock probably would also be considered an asset includible in gross assets for franchise tax purposes. If so, it could deprive a corporation wholly engaged in the real estate business of classification under Art. 9. Such a result would be inequitable, particularly where the corporation does not engage in frequent purchases and sales of its own stock.

Usually the provisions of Section 182 are strictly construed. In the case mentioned, the situation may be corrected through a formal reduction in the capital stock and a corresponding cancellation of treasury stock. The Tax Commission would probably give the taxpayer an opportunity to take the necessary procedure in order to come within the 10% limitation before changing the classification.

Use of Standard Forms

Benjamin Grund, Chairman of the Committee on Federal Taxation, recently wrote to the Commissioner of Internal Revenue asking whether the Bureau approved the practice of attaching profit and loss statements and supporting schedules, balance sheets, reconciliation of book and taxable income and analysis of surplus, in lieu of filling in the information on the return form.

Deputy Commissioner E. I. McLarney replied that the submission of separate profit and loss statements in any form in lieu of the completion of page 1 of the corporation and partnership returns has a number of objectionable features which makes such a practice undesirable.

Also undesirable is the submission of substituted profit and loss statements in lieu of separate Schedule C (Form 1040). The present special design and dual purpose feature of the official form is lost where that is done.

With respect to the presentation of the supporting data required on the various other schedules of the return forms, the Bureau does not object to the submission of the information in separately attached schedules. Where that is done the attached schedules must be complete in all details and must be in the same form as the schedules on the return.

The State Tax Commission has considered this problem on several occasions and is insistent that the forms provided be used in submitting the required information. Several years ago the Tax Commission urged our committee to assist it in informing accountants and taxpayers of its requirements in this respect. The Tax Commission will return forms that are not filled in as required and there is always the danger that a return might be considered as not a proper return where the information is attached on schedules and not on the return form itself.

Combined Returns

At the technical meeting held on April 24, 1951, Frederick J. McCarthy spoke on New York State Franchise Tax problems. The talk included an excellent summary on combined returns. Mr. McCarthy pointed out that the law speaks of combined reports rather than consolidated reports. The term combined is not as broad and comprehensive as consolidated and, in Mr. McCarthy's opinion, reflects more correctly the restricted jurisdiction of the State Tax Commission as compared with the Commissioner of Internal Revenue. For example, foreign corporations operating exclusively without the State cannot as a general rule be required to be included in a combined report.

The filing of a combined report is always "in the discretion of the Commission." For that reason application must be made to the Tax Commission for permission to file such a return.

To qualify for inclusion in a combined report one corporation must own 95% of the stock of another corporation or the same interests may own 95% of the stock of the corporations desiring to file such report. This is different from the federal rule.

No consolidation is permitted under Article 9 except that if substantially all the capital stock of a real estate corporation taxable under Section 182 is owned or controlled by a corporation taxable under Article 9A, or if substantially all of the capital stock of such real estate corporation and of such business corporation are owned or controlled by the same interests, and if the business corporation uses or occupies any material part of the property of the real estate corporation, the real estate corporation becomes taxable under Art. 9-A, and its inclusion with the business corporation in a combined report may be permitted or required.

Under new Art. 9-A, inter-company holdings are eliminated; under the former law there was no such provision, with the result that certain items of capital were taxed twice.

Allocation in Combined Reports

Under the receipts factor, inter-company receipts are eliminated in computing New York receipts. Under the property factor, gross rents do not include inter-company rents if the lessor and lessee corporations are included in the combined report.

No adjustments are made under the payroll factor, since this factor takes into account wages, salaries and other compensation paid for services only where there exists an employer-employee relationship.

Allocation is made on the combined factors of all the corporations. The optional procedures in allocation provided for in Section 210.6 (Arts. 400, 410, 420, 440) are not available to corporations taxed on a combined basis.[6]

In addition to the elimination of inter-corporate stockholdings in computing combined business and investment capital, inter-corporate bills, notes and accounts receivable and payable are also eliminated.

In determining combined entire net income, inter-company dividends should be eliminated.

Assessment of Tax—Combined Return

The tax may be assessed against any one or more of the included corporations in such proportions as the Tax Commission may determine. However, each corporation is liable for the entire tax. Usually the tax is assessed against the parent company.

In a combined report each included corporation is required to pay a minimum tax of $25, except the corporation which pays the combined tax. This tax is in addition to any tax measured by subsidiary capital not eliminated in the combined report.

Investments in subsidiaries included in a combined report are eliminated. Instead the underlying assets and liabilities are reflected in the final figures.

[6] Art. 401.

Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

THE KAISER-FRAZER DECISION

Accountants have more than a passing interest in a recent decision in the United States Court of Appeals. The decision referred to was in the case of *Kaiser-Frazer Corporation* v. *Otis & Co.*, and since the present result hinged upon a summary of earnings table included in a registration statement that had been filed with the SEC and became effective, it seems an appropriate subject for this department. As will be seen, however, the case has implications of a rather far-reaching nature and may cause accountants quite a bit of head scratching. A review of this case by the United States Supreme Court has been requested.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 152—October Term, 1951

(Argued January 14, 1952 Decided April 7, 1952.)

Docket No. 22113

KAISER-FRAZER CORPORATION,
Plaintiff-Appellee,

—against—

OTIS & Co.,
Defendant-Appellant.

Before:

AUGUSTUS N. HAND and CLARK,
Circuit Judges, and BRENNAN,
District Judge.

Appeal from the United States District Court for the Southern District of New York.

From a judgment in the amount of $3,120,743.51 in favor of the plaintiff Kaiser-Frazer Corporation against the defendant Otis & Co., the latter appeals. Judgment reversed and case remanded with directions to dismiss the action.

BEN HERZBERG and ARNOLD, FORTAS & PORTER, *Attorneys for Otis & Co., appellant;* Abe Fortas, Ben Herzberg, Milton V. Freeman, and Lawrence R. Eno, of counsel.

WILLKIE OWEN FARR GALLAGHER & WALTON, *Attorneys for Kaiser-Frazer Corporation, Appellee;* Mark F. Hughes, Walston S. Brown, Helmer R. Johnson, Vincent R. Fitzpatrick and Richard Owen, of counsel.

AUGUSTUS N. HAND, *Circuit Judge:*

On February 3, 1948, the plaintiff, Kaiser-Frazer Corporation, an automobile manufacturer, entered into a contract for the sale of 900,000 shares of its unissued common stock at $11.50 per share to Otis & Co., First Cali-

LOUIS H. RAPPAPORT, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s., and is also a member of the American Institute of Accountants and of the American Accounting Association.

fornia Company, and Allen & Co., securities underwriters, who in turn were to offer the stock for sale to the public at $13. per share. The purchasers were to take title to the stock severally, Otis and First California having agreed to purchase 337,500 shares each, and Allen & Co. to purchase the remaining 225,000 shares. The contract made the purchasers' obligation to accept the stock subject to certain conditions which, so far as relevant here, may be summarized as follows: (1) Kaiser-Frazer's counsel was to deliver an opinion satisfactory to the purchasers' counsel that there were no material legal proceedings pending against the issuer; and (2) the registration statement (including the prospectus filed with the Securities & Exchange Commission pursuant to the Securities Act of 1933) was to comply with the Act and the Regulations of the SEC "* * * and neither the Registration Statement nor the Prospectus [were to] contain any untrue statement of a material fact nor omit to state any material fact required to be stated therein or necessary in order to make the statements therein not misleading * * *" It is undisputed that the registration statement (including the prospectus) was filed with the SEC and became effective on February 3, 1948, the day the contract was signed. The contract set February 9, 1948 as the closing date, at which Kaiser-Frazer was to have delivered the stock to the purchasers, and the latter were to have paid the purchase price. On the day of the closing, however, the representatives of Otis and First California refused to accept the proffered stock, assigning as their reason therefor, the rejection of the opinion of Kaiser-Frazer's counsel that no material litigation was then pending which would affect the issue of the stock. Apparently, Otis and First California rejected the opinion of Kaiser-Frazer's counsel because a suit to enjoin the pending stock issue had been instituted in Michigan on the morning of February 9, 1948, by a Kaiser-Frazer stockholder named Masterson.[1] Shortly thereafter, Kaiser-Frazer initiated the present action against Otis in the District Court for the Southern District of New York. Federal jurisdiction was invoked on the ground of diverse citizenship of the parties.[2] The complaint —which was amended—alleged three claims, the first of which charged that Otis was guilty of a breach of contract for failing to accept and pay for 337,500 shares of stock and asked for damages in the total amount of $17,419,819, composed of $1,856,250 general damages and $15,563,569 special damages arising out of manufacturing profits lost by Kaiser-Frazer on account of Otis' breach. The second claim was stated as an alternative to the first and alleged that Otis had inspired the institution of the stockholders' suit by Masterson and had repudiated the contract without excuse; the damages prayed for were the same as under the first claim. The third claim was that Otis had wrongfully induced First California not to perform the latter's obligation under the contract to purchase 337,500 shares of stock and asked for damages in the amount of $1,856,250.

The defendant's answer to the complaint set forth several affirmative defenses, only two of which are in issue on this appeal: The first, that the purchasers were relieved of any obligation under the contract because of the filing of the suit by Masterson, and the second, that the registration statement contained false and misleading statements. After an extensive trial lasting six weeks, the district judge made findings of fact in favor of the

[1] The representative of Allen & Co. at the closing expressed a willingness to perform despite the action of Otis and First California.

[2] Kaiser-Frazer is a Nevada corporation and Otis is a Delaware corporation qualified to do business in New York.

plaintiff on substantially all of the points in issue, and entered judgment for the plaintiff in the amount of $3,120,743.51.

Several errors are assigned by the defendant on this appeal, most of which deal with the findings of fact of the trial judge. However, because of the view we take of the case, we need discuss only one of the alleged errors; namely, whether the district court was correct in finding that the plaintiff had not misrepresented but had adequately disclosed its profit for the month of December 1947 in the statement of earnings which it set forth in the prospectus; for, if the prospectus contained such a misrepresentation, as will appear, neither Otis nor First California was under any obligation on February 9, 1948 to accept the stock and Otis would have a complete defense to all the causes of action stated in the complaint.

The stock issue which was the subject of the contract at bar was to have been the third issue of Kaiser-Frazer stock since its organization in 1945, and its first issue after January 1946. In the early part of 1948, when this issue was contemplated, Kaiser-Frazer was as yet a newcomer to the automobile industry; production of its cars did not get underway until late 1946, and volume production was not achieved until the spring of 1947. While the post-war period in the automobile industry was abnormal in the sense that a strong "sellers'" market prevailed, nevertheless the problems of production and competition confronting one in Kaiser-Frazer's position were of sufficient magnitude to make the venture highly speculative. Under such circumstances it is evident that the prospective purchaser of Kaiser-Frazer stock would rely heavily on the corporation's sales and earnings during the last quarters of 1947 as the best and perhaps the only available indication of its ability to compete with the established automobile manufacturers. Indeed, the defendant contends that without a favorable picture of earnings for that period the proposed stock issue could not have been made. In any event, Kaiser-Frazer elected to set forth in the prospectus a table summarizing its sales and earnings in capsule form and "designed to apprise the investor, in a convenient fashion, of the financial results of the operation of the business * * *" SEC Accounting Series Release No. 62, 3 CCH, Fed. Sec. Law Rep. para. 72,081. It is apparent, then, that the table summarizing earnings was an important factor in the sale of the stock and, that being so, failure to make full disclosure therein of all the facts bearing upon the Corporation's earnings constituted a breach of the contract and violated the Securities Act of 1933 as well. 15 U. S. C. A. §77 *l*.

The following is a quotation of the summary earnings table, with text and footnotes, as it appeared in the prospectus:

"SUMMARY OF CONSOLIDATED SALES AND EARNINGS

The following summary reflects consolidated sales and earnings of the Corporation from its inception to December 31, 1947. The information for the period ended December 31, 1945, and the year ended December 31, 1946 as shown in the table, and for the six months ended June 30, 1947 (as explained in note 2) has been prepared from profit and loss statements examined by Touche, Niven, Bailey & Smart and should be read in conjunction with the financial statements for such periods included herein and the accountants' report thereon. The information shown in the table for the eleven months ended November 30, 1947, and the breakdown into the three fiscal quarters and the two months period comprising such eleven months, has been taken from profit and loss statements prepared by the Corporation from its books and accounts, without audit, and should be read

in conjunction with the unaudited eleven months financial statements and schedule included herein. The tentative information shown in the table for the quarter and for the year ended December 31, 1947, has been prepared by the Corporation from its books and records, without audit, on the basis of a preliminary 1947 closing made at January 23, 1948.

Period	*Sales and Miscellaneous Income*	*Cost of Sales*	*Selling and Administrative Expenses*	*Other Deductions or Credits* —Net*	*Net Profit or Loss**
From August 9, to December 31, 1945..	$ 10,979	$ 224,607	$ 551,988	$ 7,104	$ 772,720*
Year ended December 31, 1946	11,657,972	28,092,530	2,940,877	90,754*	19,284,681*
Eleven months ended November 30, 1947.	227,560,032	204,674,595	6,751,960	637,729	15,495,748
Quarter ended March 31, 1947 (2)	27,305,035	29,366,660	1,093,542	81,127	3,236,294*(1)
Quarter ended June 30, 1947 (2)	53,142,946	50,255,274	1,640,776	198,641	1,048,255 (1)
Quarter ended September 30, 1947 ...	78,527,735	67,890,777	2,150,261	209,388	8,277,309 (1)
Two months ended November 30, 1947.	68,584,316	57,161,884	1,867,381	148,573	9,406,478 (1)
	*	* * * *	*		
Quarter ended December 31, 1947 (4)...	101,999,563	84,519,665	3,850,916	213,121	13,415,861 (1)
Year ended December 31, 1947 (4)	260,975,279	232,032,376	8,735,495	702,277	19,505,131 (1)

NOTES:

(1) But for the operation of the loss carry-over provisions of the Internal Revenue Code, and the loss for the three months ended March 31, 1947, the profits shown above would have been subject to Federal income taxes in approximately the following amounts:

Quarter ended June 30, 1947	$ 420,000
Quarter ended September 30, 1947	3,310,000
Two months ended November 30, 1947	3,765,000
	$7,495,000
Less reduction in tax due to loss for quarter ended March 31, 1947	1,295,000
Eleven months ended November 30, 1947	$6,200,000

On a similar basis the Federal income taxes applicable to the quarter and to the year ended December 31, 1947 would have been $5,365,000 and $7,800,000 respectively.

(2) The aggregate information for the six months ended June 30, 1947, agrees with the profit and loss statement for such period included herein and reported upon by Touche, Niven, Bailey & Smart. However, the segregation of such aggregate information so as to show the two quarters separately has been prepared by the Corporation, without audit.

(3) The 'excess of fair value of shares issued to Graham-Paige Motors Corporation over book amount of net tangible assets received therefor' is to be written off by charges to profit and loss over a period of five years beginning January 1, 1948. This will result in a charge of $542,943 annually.

(4) The tentative information for the quarter and year ended December 31, 1947, reflects various substantial year end adjustments including provision for certain reserves and a material increase in inventories to conform to the results of the complete physical inventory taken by the Corporation as of December 31, 1947. In connection with the loss of the Corporation for the fiscal year ended December 31, 1946, attention is called to the fact that the Corporation made no sales until the fourth quarter of such year. Sales in such quarter amounted to $11,504,443, as compared with sales of $78,466,238 in the third quarter of the fiscal year 1947."

The above table contains no figure purporting to be the December 1947 profit as such; however, by subtracting the profit for the two months ending November 30, 1947 from the quarter ending December 31, 1947 profit, a figure of $4,009,383 is obtained which one would naturally assume to represent the profit of the Corporation for the single month of December 1947. Kaiser-Frazer argues that the average person reading the prospectus would not make this arithmetical calculation and hence his judgment would not be affected by any consideration of what the December profit was represented to be.[3] But, as pointed out earlier, because of the comparatively brief earnings record of the Corporation and the speculative nature of the venture in which it was engaged, we think that the average prospective purchaser of Kaiser-Frazer stock would have made the subtraction and would have concluded that the December earnings totalled nearly four million dollars. It is, however, sufficiently clear from the record that December earnings from the Corporation's operations were nowhere near that amount, but were rather in the neighborhood of $900,000. The difference in amount was due to the fact that a physical inventory was taken in the latter part of December 1947, at which time it was discovered that the Corporation had a much larger inventory than had been anticipated. The net amount of the adjustment that was made to reflect this fact was the sum of $3,371,155, which Kaiser-Frazer simply included under the final quarter's earnings in the summary. Actually, the increase in profit resulting from the larger inventory was allocable not only to the month of December or the last quarter of 1947, but to the entire year's operations and in part to prior years; for in effect the larger inventory meant that Kaiser-Frazer had been charging too much to cost of sales for those periods. Indeed, the Corporation's "Consolidated Statement of Income and Expense" for December 1947, prepared for its own use, summarized the month's operation as follows:

"Net Profit or (Loss) for the Month of December, 1947	$ 638,226.97[4]
Prior Months' Adjustments (see notes)	3,371,155.56"

Moreover, Kaiser-Frazer's own expert accounting witness, Hollis, did not deny that the inventory write-up should have been allocated to prior periods. He did, however, give testimony and presented exhibits to the effect that a complete reallocation of expenses that had been charged to December would yield a profit of about $2,900,000, which in

[3] We do not see how Kaiser-Frazer can derive any comfort from this argument. Even assuming that there was no representation as to the profit for the month of December 1947, nevertheless it cannot be disputed that the profit for the final quarter was shown in the summary as amounting to $13,415,861. This figure, however, included the inventory write-up which should have been reallocated to prior periods. See *infra*. Using Kaiser-Frazer's own reallocation of the inventory write-up, the final quarter profit was only $11,170,597. Consequently, at best there was a misrepresentation of the final quarter profit to the extent of $2,245,264.

[4] Some of the inventory write-up, approximately $260,000, was allocable to the month of December which accounts for the difference between $638,226.97 shown in this statement as December profit and the $900,000 figure referred to earlier in the text.

turn would mean that the amount of the overstatement of December earnings was only a little over $1,000,000. But his testimony on this point is unacceptable, for his method of reallocation was entirely opposed to the accounting system that had been utilized by the Corporation and upon which the summary was based. For example, he wrote off steel variances[5] in the amount of $1,066,027 paid in December, whereas the Corporation had in the past always charged such variances as an expense to the month in which the steel was purchased; also, he wrote off all advertising expenses for the month of December although it was not disputed that the Corporation had advertised extensively in that month.[6]

The district court found that the "summary of consolidated sales and earnings for the final quarter of the year 1947, set forth on page 7 of the prospectus, was computed in accordance with accepted accounting procedures," and that it was not misleading. With this conclusion we cannot agree. For, regardless of whether its accounting system was a sound one, Kaiser-Frazer stated its earnings in such a way as to represent that it had made a profit of about $4,000,000 in December 1947. This representation was $3,100,000 short of the truth. Concededly, the profits for the year as a whole were substantially unaffected by the overstatement of December earnings, but the prospective purchaser was entitled to a full disclosure of all the facts that were known to the Corporation at the time the prospectus was issued; and the Corporation knew on February 3, 1948 that its profit for the month of December 1947 was less than $1,000,000. The source of the profit as stated in the prospectus for December could have been readily disclosed by a footnote to the earnings table. The footnote that appeared in the prospectus[7] as issued was entirely insufficient for this purpose. No one reading it would have been put on notice that the actual profit for December was less than a fourth of what was indicated by the table.

Kaiser-Frazer urges that since Otis had full knowledge of all the facts prior to the time it entered into the underwriting agreement, Otis cannot now rely on such facts as constituting a breach of warranty. Factually there is some support for Kaiser-Frazer's contention; the testimony at the trial indicates that representatives of Otis at least were informed of the actual December earnings and apparently took part in the preparation of the registration statement and the prospectus. But whatever the rules of estoppel or waiver may be in the case of an ordinary contract of sale, nevertheless it is clear that a contract which violates the laws of the United States and contravenes the public policy as expressed in those laws is unenforceable.[8] *E. E. Taenzer*

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[5] Steel variance is the excess of the price paid by the Corporation for steel purchased over the price at which the steel was included in inventory.

[6] The December advertising expenses, amounting to $758,000, were not included in the summary shown in the prospectus because the billings for that month had not been cleared through Kaiser-Frazer's accounting office when the books were closed. Consequently, when the accountant Hollis wrote off the November advertising expenses, which had been charged to December, his final profit figure of $2,900,000 did not include any charge at all for advertising expenses.

[7] This footnote is footnote (4) in the summary earnings table quoted earlier in the text.

[8] Further support for our holding may be found in §14 of the Act of 1933, 15 U. S. C. A. §77n, which provides as follows:

> "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

The broad language of this section may be construed to brush aside ordinary contract principles of estoppel and waiver that might otherwise apply to contracts for securities, including underwriting agreements.

& Co. v. *Chicago, R. I. & Pa. Ry.*, 6th Cir., 191 Fed. 543, cert. denied, 223 U. S. 746; *cf. Sola Electric Co.* v. *Jefferson*, 317 U. S. 173. This is so regardless of the equities as between the parties, for "* * * the very meaning of public policy is the interest of others than the parties and that interest is not to be at the mercy of the defendant alone." *Beasley* v. *Texas & Pacific Ry.*, 191 U. S. 492, 498. Any sale to the public by means of the prospectus involved here would have been a violation of the Securities Act of 1933, 15 U. S. C. A. §77 *1* (2). While it may be argued that the enforcement of the underwriting contract according to its terms would result only in the sale of the stock to Otis and that such a sale would not violate the Act, see 15 U. S. C. A. §77 d (1), we are satisfied that the contract was so closely related to the performance of acts forbidden by law as to be itself illegal. We cannot blind ourselves to the fact that the sale of this stock by Kaiser-Frazer, though, in so far as the particular contract was concerned, was a sale only to the underwriters, was but the initial step in the public offering of the securities which would necessarily follow. The prospectus, which has been found to have been misleading, formed an integral part of the contract and the public sale of the stock by the underwriter was to be made and could only have been made in reliance on that prospectus. 15 U. S. C. A. §77 e (b) (2). We therefore conclude that the contract was unenforceable and that Kaiser-Frazer was not entitled to recover damages for Otis' breach thereof. See Restatement of Contracts, §§580, 598. It also follows from what has been said that there having been no enforceable contract, Otis is not liable in damages for interfering with the performance of the underwriting contract by First California.

The judgment is reversed and the case remanded to the district court with directions to enter judgment for the defendant.

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

Employers Hearing Request before Referee Concerning Merit Rating Charges and $10 Deposit Requirement

GENERALLY an Employer who disputes a payment of benefits to a former employee is required to post a $10 deposit at the time he files his objection to the payment of benefits and submits a request for a hearing before an Unemployment Insurance Referee, in accordance with Section 620 of the Unemployment Insurance Law.

However, in connection with an Employer's request for a hearing solely with respect to the propriety of experience rating charges it was held in Referee's Case #E-51-52R, decided July 11, 1952, that, with respect to the propriety of the experience rating charges, a $10 deposit is not required. The Referee held that the deposit feature contained in Section 620 of the Unemployment Insurance Law, was designed as a protective measure for claimants and rights to benefits were not in issue or affected.

In the case at bar the Industrial Commissioner had issued a determination to the Employer in the form of a "Notice of Experience Rating Charges", charging the Employer's account with benefit payments made to a certain claimant. The Employer objected to the charge on the ground that he was not the chargeable employer and requested a hearing. He posted a $10 deposit but made no objection concerning the claimant's right to benefits, merely stating that the individual involved had not been employed by the firm since a certain date and that consequently no charges should have been made against its account for any Unemployment Insurance benefits paid to that individual.

Prior to the scheduling of a hearing a request for cancellation was submitted by the Employer after it had learned that the claimant was entitled to the benefits involved which could be charged to the Employer's account in accordance with the amended Unemployment Insurance Law.

In his opinion the Referee pointed out that upon the Employer's withdrawal of his request for a hearing there remained no question as to the propriety of the charges to the Employer's account. The sole question remaining was whether or not the Employer should have his $10 deposit refunded to him.

Section 620 of the Unemployment Insurance Law provides:

> "Referee's Hearings: 1. Disputed claims for benefits.
>
> "(a) A claimant who is dissatisfied with an initial determination of his claim for benefits or any other party affected by such determinations may . . . request a hearing.
>
> "(b) When the initial determination of a claim for benefits, upon which a hearing

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has been requested, involves the question . . . whether an employer has fully complied with the obligations imposed by this article, written notice of the hearing shall be given to such . . . employer . . . and thereupon he shall be deemed a party to the proceeding, entitled to be heard. . . .

"(c) Any employer who requests a hearing pursuant to the provisions of *paragraph* (a) of this subdivision shall at the same time deliver to the commissioner a deposit in the amount of ten dollars. The commissioner shall hold such deposit in his custody in an account separate from the fund until the referee makes his decision. If the referee modifies or overrules the initial determination of the claim, the commissioner shall return such deposit to the employer. If the referee confirms the initial determination, the commissioner shall pay such deposit into the fund and credit the general account. . . .

"2. Contested determinations, rules, or orders. Any employer who claims to be aggrieved by the industrial commissioner's determination of the amount of his contributions or by any other rule or order of the commissioner under any provision of this article may apply to the commissioner for a hearing within twenty days after mailing or personal delivery of notice of such determination, rule, or order. . . ."

It was pointed out in the Referee's decision that the notice of experience rating charges is a determination with a dual aspect. It indicates the propriety of the charge and of the payment of benefits on which such charge was based. The Employer in this case made it clear in his letter of objection to the determination and also in his letter of withdrawal that such objection was confined solely to the question of the propriety of the benefit charge to his account. It was held therefore that since he had not intended to contest the claimant's right to benefits, he was not required to make such deposit and the return of the same to the Employer is not precluded under the law.

Filing of Employer's Appeal on Issue of Coverage and Question of $25 Deposit

In Appeal Board Case #27,882-51 decided April 25, 1952, the Appeal Board held that an Employer's appeal in a benefit claim case on the issue of the Employer's coverage under the law does not require a deposit of $25, pursuant to Section 621 of the Unemployment Insurance Law. The object of the appeal is the Employer's liability for contributions and the effect on claimant's rights to benefits was only incidental in the case at bar.

The facts in this case were: A sales clerk unemployment insurance benefit claimant filed her application for benefits and reported that she had been employed by the Employer, who she believed was covered by the Unemployment Insurance Law. The Employer claimed that he was not covered because he employed fewer than 4 persons for the statutory period. The Employer's records were maintained by an accountant who made monthly visits. The Employer did not produce any books or records at the hearing but gave oral testimony. The hearing was adjourned to a later date and the Employer was directed to produce Social Security reports, check books, cash books, income tax reports, and check stubs for the years 1947 to 1949.

The Employer failed to appear at the adjourned hearing, and the Referee ruled on the basis of the credible evidence deduced at the hearing that 4 employees worked for the Employer during the entire period of claimant's employment and that the Employer was accordingly subject to the law and liable for contributons from January 1, 1948. The Employer appealed the Referee's decision to the Appeal Board. The case had arisen originally because the benefit claimant had requested the hearing before the Referee who found in favor of the claimant.

The Appeal Board was of the opinion that the Referee made proper findings of fact and correctly determined the issues involved in this case, mainly that the benefit claimant was entitled to Unemployment Insurance because she had been employed in covered employment; however, since this case, insofar as the Employer was involved, was

directed towards the issue of this employer's coverage under the law and its consequent liability for Unemployment Insurance contributions, the deposit of $25 made by the Employer upon her appeal to the Board should be returned as not required.

Services Performed Without Remuneration Held "Week of Employment"

It was decided by an Unemployment Insurance Referee in Case #525-517-52R, June 10, 1952, that a week in which a claimant did some work in employment for an employer liable for contributions should be considered a "Week of Employment" as defined in Section 526 of the Law, even though the claimant did not receive remuneration for work performed in the particular week. The claimant was formerly a clerk who filed a benefit claim February 4, 1952. He was ruled ineligible because he did not have 20 weeks of employment subject to the Unemployment Insurance Law in his base period, February 5, 1951, through February 3, 1952. The Employer had reported that the claimant had had 19 weeks of employment with total earnings of $950. The claimant had been absent on November 12, 1951, because of illness and had resumed work on November 13, 1951, through the balance of the week and was paid. He reported again for work on Monday, November 19th, worked all day and also worked from 7:00 to 9:00 A.M. on Tuesday, November 20th, when he left because he was ill. He did not work the rest of the week and he received no remuneration for his services on November 19 and 20.

The Referee held that since the claimant had performed services for his Employer on November 19 and 20, those services should be considered as work performed, notwithstanding the fact that he received no remuneration therefor. He further found that the claimant was therefore eligible for benefits inasmuch as he had had 20 weeks of employment subject to the law in his base period.

AN ADIRONDACK VIEW

Vacations. Well, they are now mostly over. Without bothering our members with a galloping poll, we guess that the statistics are about as follows.

Out of each thousand members:

200—went to the seashore
200—went to the mountains
396—went somewhere in between
4—went abroad
200—didn't take a summer vacation this year
50—had automobile accidents
10—climbed a mountain
900—got sunburned
50—got poison ivy
799—didn't get back to normal for two weeks
300—paid extra for US money in Canada
4—who went abroad, prefer to live in the US
1000—did some talking about US politics
200—did some fishing
100—caught some fish

It was the biggest vacation-summer we ever had. Cabins full, roads full—the only place left for solitudenous thought was three miles back in the mountains.

LEONARD HOUGHTON, CPA
Adirondack "Chapter."

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Book on Office and Staff Administration

A book of interest to practitioners, office and staff managers, and those who aspire to these positions, was recently published. It is ACCOUNTANT'S OFFICE PRACTICE by Charles S. Rockey, C.P.A., a veteran practitioner. It contains considerable material, and forms, on the subjects of office and staff administration, as well as data on virtually every other aspect of running an accounting practice. Though the procedures of a large office are the basis for the information therein, it nevertheless can be very informative for small and growing firms.

Tax Examination Records and Follow-Up

An office record of every tax examination is very valuable for information purposes as well as for its use as a check-list of follow-up procedures. The record should contain details as to the time, dates, and place of the examination, as well as the examiner's name; the details of the changes agreed to, if so; protest, conference, and litigation history; and finally a check list of at least the following details:

Journal entries covering adjustments, tax payable, and accrued interest, submitted to client.

Refund claims to be filed, if any.

Adjustments to be made of filed but unaudited returns.

Changes to be reported to other tax departments.

Client billing.

Etc.

Readers are requested to submit forms used by them for this purpose. It is hoped that one such form, and further discussion of its use, may be published in the near future.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Specimen Staff Manual

Much has been said and written about the value of a staff manual as a means of improving staff performance, acheiving uniform report quality, informing staff as to office rules, and other reference material. However, no specimens have been reproduced (so far as here known) because of the considerable bulk of a manual, and its personalized nature.

A copy of one manual, entitled "Report Manual" is available for reference at the library of the American Institute of Accountants. It deals essentially with the preparation of financial statements and includes specimen report forms, letter paragraphs, comments, opinions, discussion of the essential disclosures in the individual exhibits, and other valuable data. Though it is limited to report preparation, essentially, it also contains considerable other related data of interest and benefit. Accountants who have thought of compiling a manual, and those who

(Continued on page 576)

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS department is a clearing house for questions, problems, comments and rulings, regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Abnormal Income in Excess Profits Taxable Year

The World War II predecessor (Sec. 721) of the present Section 456 of the Internal Revenue Code was probably the most prolific source of relief to the harried taxpayer under the prior law. However, a good deal of the succor in the law has been withdrawn by the legislative determination to substitute arithmetical formulae for so-called "subjective" relief.

The law provides for two types of abnormal income: (1) abnormal by nature and (2) abnormal by amount. The Regulations seem to negate this distinction by their requirement that only income which has not appeared in the four previous taxable years may qualify as abnormal by kind. This definition by the Bureau makes the statutory distinction redundant as both types of abnormalities would be encompassed by the provision for abnormality by amount. However, it will apparently take litigation to change the Commissioner's position on this point.

The law sets forth the classes of abnormal income within which the items must be grouped. The current Act omits the class of abnormal income which probably gave the greatest amount of relief under the World War II Act—income arising out of research and development of tangible property, which extended over a period of more than 12 months. The Congressional Committees seemed to feel that this type of income gave rise to the greatest amount of litigation, which would seem to be a natural concomitant of the fact that it gave the maximum amount of relief. If any item of abnormal income overlaps several classes, an irrevocable election must be made as to the applicable class. This is of course most important because of the 115% rule. In applying this rule for the four year period, it must be remembered that a short taxable year is deemed a full year for this purpose.

The gross abnormal income in each class, less 115% of the average of the abnormal income for the four year (or less) test period and less an aliquot proportion of related costs and deductions yields net abnormal income. The net abnormal income is computed by class and then allocated to items within the class. The current law substitutes the term "costs or deductions relating

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to abnormal income" for the "direct costs or expenses" of the World War II law. The current term is apparently not limited to the technical concept of "direct costs" in accepted accounting terminology and it would therefore seem that every item or transaction would have to be analyzed carefully in order to determine its related costs or deductions.

Probably the greatest hurdle which the taxpayer must overcome in order to achieve some benefit under this section of the law is to attribute an item of abnormal income to another taxable year. Abnormal income is attributed to other years by item and therefore different items of the same class may be attributable to different taxable years.

Items of abnormal net income are allocated to taxable years in the light of the events of their origin. The allocation of net abnormal income to another taxable year does not affect the computation of ordinary normal or surtax, base period net income or accumulated earnings and profits. The allocation of net abnormal income to other years under Section 456 can only affect the computation of excess profits taxes under the current Excess Profits Tax Act and cannot affect the computation of any excess profits tax under any prior law.

The Bureau's Regulations specifically restrict the allocation of abnormal income. Abnormal income may not be attributable to other years if the income is due to high prices, low operating costs, increased demand, or decreased competition. These factors may usually be determined by the use of business index numbers. The United States Commerce Department and local trade and business associations are usually very helpful in this connection.

The Regulations also refuse to permit any allocation of abnormal income which results solely from the investment by the taxpayer in assets employed in or contributing to the production of such income. This provision of the Regulations has been sustained in the case of an investment in life insurance (*Premier Products Co.*, 2 TC 445).

The principle involved in the computation of the excess profits tax under this section is that the total excess profits tax for the current year shall not exceed the excess profits which would have been payable had the net abnormal income attributable to other years been subjected to tax in those years. Full effect is given to net operating losses and unused excess profits tax credits. In the event that some abnormal income is attributable to future excess profits tax years, in no event may the additional excess profits tax in the future year exceed the saving in excess profits tax that resulted in the current year by the allocation of the abnormal income. To the extent that the abnormal income may be attributed to a taxable year which is not subject to the current Excess Profits Tax Act, there is a complete saving of excess profits taxes.

In a case where abnormal income is attributed to a future year, there may be an inadvertent and unnecessary accrual of excess profits tax. The law specifies that in the case of corporate liquidations, the abnormal income is attributed to the taxable year in which the assets are transferred or the first distribution in liquidation is made, assuming of course that this date is later than the year in which the abnormal income was received. It would therefore seem wise to think twice before liquidating a corporation which has abnormal income attributable to a future year. This is especially true since our current excess profits tax law is self-terminating on June 30, 1953. Conversely, this provision may enable a taxpayer to accelerate the abnormal income into a desirable year with minimum excess profits tax cost due to losses, a high excess profits credit, unused excess profits credit carryover, low maximum excess profits tax limitations applicable to new corporations, etc., etc.

A section in the current excess profits tax law provides that the income of a component corporation must be used in applying the 115% rule where any portion of the net abnormal income is attributable to a taxable year of the predecessor ending prior to or with the close of the taxpayer's base period.

In the event that there is no excess profits tax liability without the exclusion of abnormal income, the allocation of abnormal income to another year may not serve to increase the unused excess profits credit for the year. The relief section may only be applied to reduce the excess profits tax liability for the current year.

The World War II Act gave the Tax Court of the United States final jurisdiction on questions arising under the old Section 721 of the Internal Revenue Code. The current Act contains no such limitation and the taxpayer and the government are both entitled to full appellate review.

Office and Staff Management

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would like to make comparisons with their own, would do well to review it.

Work Paper Standardization

Many firms have not developed uniform workpapers for the reason that it is a sizable task to create a standard set of papers, copies of which could be furnished to staff members. Yet the need for uniformity, with all the attendant benefits of higher standards, time saving in preparation of schedules, etc., ease in reviewing, standard indexing, etc., is undoubtedly recognized by most practitioners.

Several courses are possible for those who desire to do something about it. First, there are several fine books which contain complete sets of work papers for the large majority of audits. Several copies of the book selected could be purchased, revisions made where deemed necessary, and they then can be circulated among staff members. the computation of time and a half on One copy should be kept in the staff-room permanently. In time, men will tend to conform with the specimens in the books. The trend will be speeded up if staff members are reminded, over an extended period, that they are expected to comply with the standards furnished them. Further, those who review the papers should call attention to unwarranted non-compliance.

Another method is to purchase standard workpaper sets which are published by a few printeres who also furnish pads of each type of schedule. Such sets should also be modified, as suits the needs of the individual practitioner, and then distributed to the staff for their guidance.

A third method, one that takes considerable time and may be quite costly, is the preparation of sets of standard papers by an individual accounting firm. In this instance, obviously, the fullest play of the firm's ideas can be given effect.

Staff Working Hours

Wage Hour examiners are checking accounting firms' payrolls for failure to observe overtime rules. A number of cases have been reported where deficiencies arose, not from failure to pay overtime, but from errors in calculating overtime. The major cause was the computation of time and a half on the basis of a forty hour week when, in fact, the normal work week was found to be less than 40 hours. On this ground the hourly rate, and the overtime premium, were adjusted upwards.

This hazard should be recognized and it would be well if every firm checked their status in that respect.